

CLERK'S COPY.

439

653307

Sup. Ct.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 354

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

ELLIOTT H. WHEELER AND HOLLO C. WHEELER,
EXECUTORS OF THE ESTATE OF JOHN H. WHEELER,
DECEASED, CORNELIA W. GOOD, ET AL.

ON WRIT OF HABEAS CORPUS TO THE UNITED STATES CIRCUIT COURT
OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR HABEAS CORPUS FILED AUGUST 18, 1944

HABEAS CORPUS GRANTED OCTOBER 19, 1944

No. 10538

United States
Circuit Court of Appeals
For the Ninth Circuit.

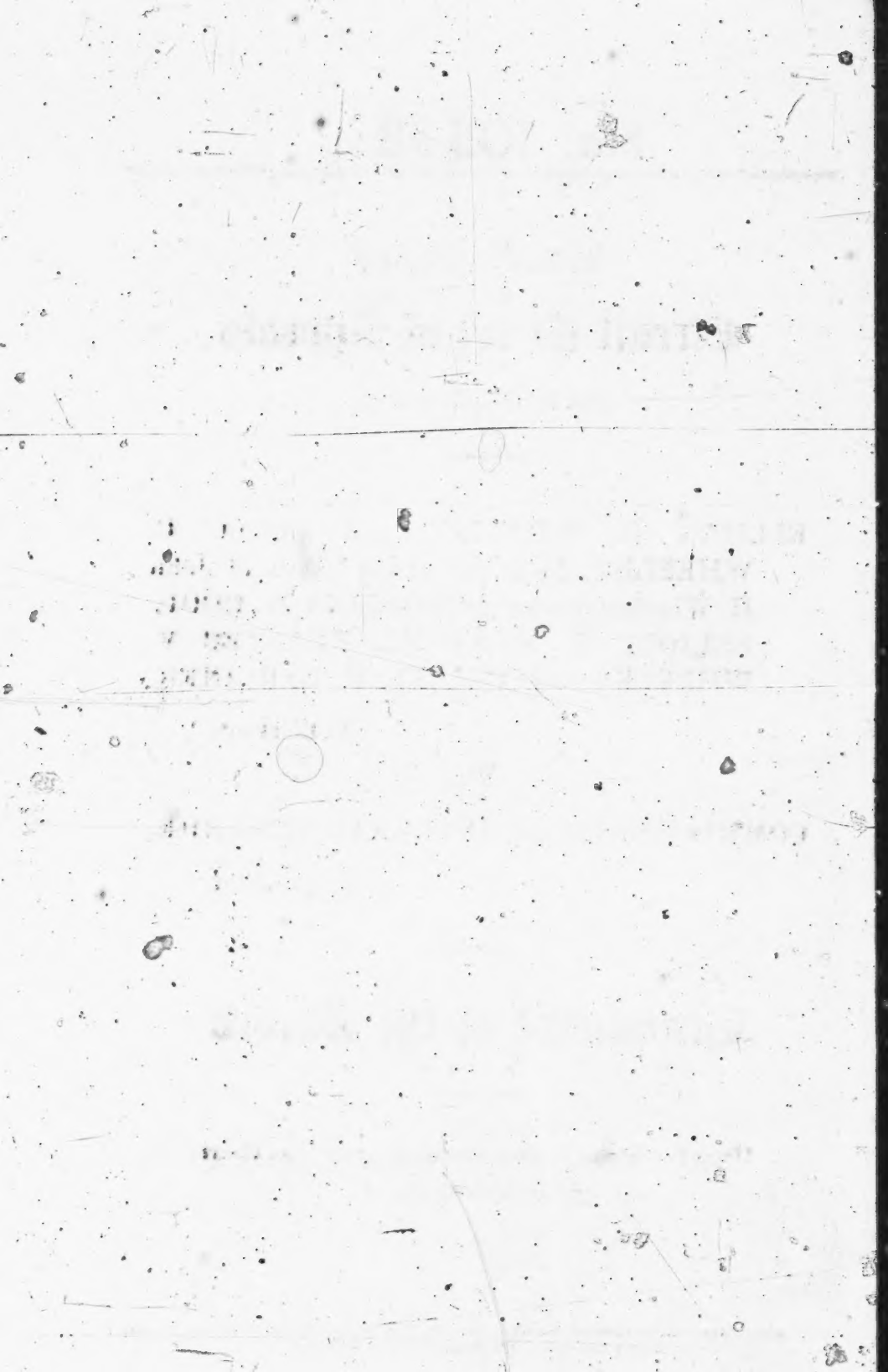
ELLIOTT H. WHEELER and ROLLO C.
WHEELER, Executors of the Estate of John
H. Wheeler, deceased, CORNELIA W. GOOD,
ELLIOTT H. WHEELER, FRANCES V.
WHEELER and YSABEL F. BERLINER,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of the Record

Upon Petition to Review Decisions of the Tax Court
of the United States



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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italics*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italics* the two words between which the omission seems to occur.]

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APPEARANCES:

For Taxpayer:

**VINCENT H. O'DONNELL, Esq.,
JOHN D. BRETHAUER, C.P.A.,**

For Comm'r:

HARRY R. HORROW, Esq.,

Docket No. 107255.

**ESTATE OF JOHN H. WHEELER, deceased,
ELLIOTT H. WHEELER, and ROLLO G.
WHEELER, Executors,**

Petitioner,

vs.

**COMMISSIONER OF INTERNAL REVENUE,
Respondent.**

DOCKET ENTRIES

1941

May 12—Petition received and filed. Taxpayer notified. Fee paid.

May 12—Copy of petition served on General Counsel.

May 12—Request for hearing in San Francisco, Calif., filed by taxpayer. 5-12-41 copy served.

May 26—Notice of appearance of John D. Brethauer, as counsel for taxpayer filed.

Jul. 8—Answer filed by General Counsel.

Jul. 15—Copy of answer served on taxpayer. San Francisco, California.

1942

Feb. 25—Hearing set March 23, 1942—San Francisco, California.

Mar. 28—Hearing had before Mr. Arnold on merits—Submitted. Counsel moves to consolidate Dockets 107255-58-60-63 and 65, granted. Stipulation of facts filed. Briefs due May 15, 1942. Replies June 15, 1942.

Apr. 20—Transcript of hearing 3-28-42 filed.

May 15—Brief filed by taxpayer. (5-16-42—3 copies received).

May 15—Brief filed by General Counsel. Copy served 5-16-42.

May 16—Copy of brief served on General Counsel.

Jun. 15—Reply brief filed by taxpayer.

Jun. 15—Reply brief filed by General Counsel. Copy served 6-16-42.

Jun. 15—Copy of reply brief served on General Counsel.

1943

Feb. 24—Opinion rendered—Arnold, Judge. Div. 12. Decision will be entered under Rule 50. 3-3-43 Copy served.

Apr. 1—Computation of deficiency filed by General Counsel.

Apr. 3—Hearing set May 5, 1943 on settlement.

Apr. 26—Consent to settlement filed by taxpayer.

Apr. 29—Decision entered. Arnold, Judge. Div. 12.

Jul. 26—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

1943

- Jul. 26—Affidavit of service by mail filed by taxpayer.
- Jul. 28—Proof of service of filing petition for review filed by taxpayer.
- Aug. 18—Statement of points with proof of service thereon filed.
- Aug. 18—Stipulation re record with agreed praecipe attached, filed. [1*]

United States Board of Tax Appeals
Docket No. 107255

ESTATE OF JOHN H. WHEELER, deceased
ELLIOTT H. WHEELER and ROLLO C.
WHEELER, Executors,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency bearing symbols San Francisco Division I.R.A.: 90-D-LB(C:TS:PD:SF:HMS) dated February 12, 1941, and as a basis for its proceeding alleges as follows:

*Page numbering appearing at top of page of original certified Transcript of Record.

1. The petitioner is a fiduciary duly authorized to act for the Estate of John H. Wheeler with business address of 1820 Mills Tower, San Francisco, California. The return for the period here involved was filed with the Collector for the First District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the petitioner on February 12, 1941.

3. The taxes in controversy are income taxes for the calendar year 1938 and in the amount of \$30,695.00. [2]

4. The determination of tax set forth in the said deficiency is based upon the following errors:

a. The assessment herein arises from the erroneous taxation of distributions received upon the liquidation of John H. Wheeler Co., on December 2, 1938 under Sec. 112(b)(7) of the Revenue Act of 1938 as taxable dividends, whereas the corporation actually had a statutory deficit as at the date of liquidation.

b. John H. Wheeler Co. was liquidated under a specific provision of the statute which required exact knowledge of the law as it stood at that time to determine if the liquidation could be effected without prohibitive taxation. The corporation is entitled to have its deficit computed in accordance with accepted law at December 2, 1938 as laid down by all court decisions promulgated before or since that date on the question of earnings or profit of corporations.

c. Section 501(b) of the Second Revenue Act of 1940 properly states the effective date of the appli-

cation of the provisions of Section 501 for the purpose of the transaction herein.

d. The retroactive provision of Section 501(c) of the Second Revenue Act of 1940 is unconstitutional insofar as it singles out one group of closed transactions of taxpayers who had filed petitions before the Board of Tax Appeals prior to [3] September 20, 1940 for immunity from its provisions, while applying the same provisions in a punitive manner to this and other corporations examination of whose transactions identical with or similar to those of the first group were pending before the Treasury Department or had not been initiated.

e. Section 112(b)(7) of the Revenue Act of 1938 was a relief provision, invitational to the liquidation of certain types of corporations. Section 501 of the Second Revenue Act of 1940 is a clarifying measure necessary primarily for the uniform application of the invested capital credit against the excess profits tax which was the subject of the Second Revenue Act of 1940. The law regarding earnings and profits was clearly and unmistakably laid down and affirmed prior to the passage of Section 501. The reasonableness of Section 501(c) in applying retroactively to open transactions and to taxpayers who are put on due notice regarding the effect of the closing of such transactions is not questioned. The singling out and penalizing of closed transactions by retroactive reversal of law is erroneous, inequitable, and in conflict with all principles of American taxation.

f. In the event it is finally held that the corpora-

tion had a surplus resulting in the distribution of taxable dividends upon liquidation, and in the further event that the dividends paid credit for the year 1936 is finally disallowed, the taxable [4] dividends assessed against the shareholders in the year 1938 should be proportionately reduced by the additional corporate income tax for the year 1936 in the amount of \$5,953.06.

7. The facts upon which petitioner relies as the basis of this proceeding are as follows:

a. John H. Wheeler Co. was organized in 1925 by John H. Wheeler and his wife Frances V. Wheeler. Securities with a cost of \$304,684.49 were exchanged for 4,918 shares of capital stock of John H. Wheeler Co. with a par value of \$100.00 per share, or an aggregate of \$491,800.00 in accordance with a permit from the State of California Commissioner of Corporations which specified that the stock of John H. Wheeler Co. could be sold for cash or issued in exchange for standard listed securities to the value of \$100.00 actual market value for each share of capital stock issued. Thereafter the company had a statutory income tax basis for its assets of \$304,684.49, but for purposes of earned surplus it had a cost of \$491,800.00, making a difference of \$187,115.51 representing unrecognized gain to the transferors upon organization.

b. In years subsequent to organization and prior to dissolution in 1938 upon sale of securities acquired upon organization the corporation used the cost of the securities to transferors as cost basis for income tax purposes but computed its surplus account on the

basis of cost of the securities to the corporation. [5]

c. On November 30, 1938 the corporation had a deficit of \$47,501.61 resulting from statutory earnings less statutory deductions and further corporate losses of \$179,314.99 representing the loss on sale of securities acquired upon organization not recognized for income tax purposes.

d. After due consideration of the meaning and intent of Section 112(b)(7) of the Revenue Act of 1938 together with its effect on the situation of the company the corporation was dissolved on December 2, 1938 specifically under and in accordance with the provision of that section. At that date the Board of Tax Appeals had stated its position regarding earnings and profits as involved herein in the cases of Chas. F. Ayers, 12 B.T.A. 284; Ida L. McKenney, 32 B.T.A. 450; Susan T. Freshman 33 B.T.A. 394; W. S. Farish & Co. 38 B.T.A. 150; F. J. Young Corporation 35 B.T.A. 860. Petitioner had no reason to contemplate or anticipate any change in law or procedure which would result in further taxation.

e. At the date of dissolution the John H. Wheeler Co. had:

Securities acquired after April 9, 1938.....	\$ 693.38
Cash	111.84
Deficit	47,501.61

Securities acquired after April 9, 1938 and cash were reported proportionately by the shareholders as long-term capital gains [6] in accordance with Section 112(b)(7)(e)(i) of the Revenue Act of 1938.

In view of the deficit no taxable dividends were reported.

f. On July 10, 1940 an examining agent concluded his examination of the records of John H. Wheeler Company in connection with the corporate return for the year 1938 and proposed and secured signed agreements for \$50.00 additional tax for minor adjustments. Notwithstanding the proposed signed agreement for 1938, a letter, copy of which is attached as Exhibit "B", was received shortly after July 19, 1940 which raised the present issue for the first time. About September 4, 1940 a thirty day letter, copy of which is attached hereto as Exhibit "C" was received by this petitioner. The proposed deficiency was protested and discussed in conference on the basis of earnings and profits as covered in the Revenue Act of 1938.

g. The deficiency notice, Exhibit "A", herein contained the first official mention of Section 501 of the Second Revenue Act of 1940.

h. The corporate tax return for the year 1936 was examined by the Treasury Department on or before July 11, 1938 and no contention was made that the 1936 dividend was not paid within the taxable year 1936. Thus the corporation, having no notice of contingent tax liability, made no provision for the 1936 proposed deficiency upon liquidation. [7]

Wherefore the petitioner prays that this Board may hear the proceeding and find that the John H. Wheeler Company had no accumulated earnings or profits at December 2, 1938 which would result in taxable dividends to its shareholders upon dissolution, and that Section 501 of the Second Revenue Act of 1940 could not be made retroactive to apply puni-

tive consequences against a transaction closed and completed under the relief section 112(b)(7) of the 1938 statute which could not have been foreseen or contemplated when the transaction was designed and consummated.

ROLLO C. WHEELER

Executor of Estate of John H.
Wheeler

ELLIOTT H. WHEELER

Executor of Estate of John H.
Wheeler

1820 Mills Tower

San Francisco, California

Counsel for Petitioner:

Vincent H. O'Donnell, Esq.

1820 Mills Tower,

San Francisco, California

John D. Brethauer, C.P.A.

504 Bank of America Building

Berkeley, California [8]

State of California

City and County of San Francisco—ss.

Rollo C. Wheeler and Elliott H. Wheeler, being duly sworn, say that they are the duly appointed, qualified and acting executors of the Estate of John H. Wheeler, deceased and they are duly authorized to and do verify the foregoing petition. They have read the foregoing petition, or had the same read to them and are familiar with the statements contained therein. The statements contained therein are true

except those stated upon information and belief and those they believe to be true.

ROLLO C. WHEELER

ELLIOTT H. WHEELER

Subscribed and sworn to before me this 9th day of May, 1941.

[Seal]

CATHERINE E. KEITH

Notary Public in and for the City and County of San Francisco, State of California. [9]

EXHIBIT "A"

Treasury Department
Internal Revenue Service
74 New Montgomery Street
San Francisco, Calif.
February 12, 1941

Office of:

Internal Revenue Agent in Charge

San Francisco Division

IRA:90-D-LB

(C:TS:PD

SF:HMS)

Estate of John H. Wheeler, Deceased,
Rollo C. Wheeler, Executor,
3377 Washington Street,
San Francisco, California.

Sir:

You are advised that the determination of the income tax liability of John H. Wheeler, deceased, for

the taxable year ended December 31, 1938, discloses a deficiency of \$30,695.00 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 74 New Montgomery Street, San Francisco, California, for the attention of Conference Section. The signing and filing of this form will expedite the closing of the return by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,

Commissioner.

By (F. M. Harless)

Internal Revenue Agent in
Charge

Enclosures:

Statement

Form of waiver. [10]

STATEMENT

San Francisco
 IRA: 90-D-Lb
 (C:TS:PD
 SF:HMS)

Estate of John H. Wheeler, Deceased,
 Rollo C. Wheeler, Executor,
 3377 Washington Street,
 San Francisco, California

Tax Liability for the Taxable Year Ended
 December 31, 1938

	Liability	Assessed	Deficiency
Income tax	\$35,246.23	\$4,551.23	\$30,695.00

In making this determination of your income tax liability, careful consideration has been given to your protest dated September 25, 1940; to the statements made at the conferences held on October 24, 1940, and January 8, 1941.

A copy of this letter and statement has been mailed to your representative, Mr. Vincent H. O'Donnell, 1820 Mills Tower, San Francisco, California, in accordance with the authority contained in the power of attorney executed by you and on file in this office.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return	\$ 34,079.26
Unallowable deductions and additional income:	
(a) Dividends	\$66,406.69
(b) Farming income	238.02
(c) Legal expense	2,700.00
	<hr/>
Net income adjusted	\$103,423.97

[11]

EXPLANATION OF ADJUSTMENTS

(a) It is held that the earnings and profits distributed in liquidation by the John H. Wheeler Company, under the provisions of section 112(b) (7) of the Revenue Act of 1938 should be determined by

applying the provisions of section 501(a) of the Second Revenue Act of 1940, and that, therefore there should be included in the decedent's taxable income as a dividend received in 1938, the amount of \$66,406.69.

(b) To the decedent's farm income of \$8,351.68 shown on the return there is added the sum of \$238.02 representing certificates of the California Prune & Apricot Growers' Association cashed by the decedent in 1938. As such certificates were not reported as income by the decedent when received, and had no cost basis in his hands, the entire proceeds received are held to be taxable income.

(c) Legal fees of \$3,708.09 claimed as a deduction on the return included fees aggregating \$2,700.00 paid to an attorney and an accountant for contesting an alleged deficiency in gift taxes asserted against the decedent for the year 1935. Such fees are held to be personal expenses and the deduction is disallowed. Section 24(a)(1) of the Revenue Act of 1938.

COMPUTATION OF TAX

Net income adjusted	\$103,423.97
Less: Personal exemption	2,500.00
Balance (surtax net income)	\$100,923.97
Less: Earned income credit (10% of \$3,000.00).....	300.00
Net income subject to normal tax	\$100,623.97
Normal tax at 4% on \$100,623.97.....	\$ 4,024.96
Surtax on \$100,923.97	30,535.90
Total tax	\$ 34,560.86
Total tax (alternative tax in case of a net long term gain or loss)	\$ 35,246.23

Computation of Tax—(Continued)

Correct income tax liability	\$ 35,246.23
Income tax assessed:	
Original, account No. 201907—First California	4,551.23
Deficiency in income tax	\$ 30,695.00

COMPUTATION OF ALTERNATIVE TAX

(Section 117(c)—Revenue Act of 1938)

Net income	\$103,423.97
Plus: Net long-term capital loss	2,141.77
Ordinary net income	\$105,565.74
Less: Personal exemption	2,500.00
Balance (surtax net income)	\$103,065.74
Less: Earned income credit	300.00
Net income subject to normal tax	\$102,765.74
Normal tax at 4 per cent on \$102,765.74	\$ 4,110.63
Surtax on \$103,065.74	31,778.13
Partial tax	\$ 35,888.76
Minus: 30 per cent of net long-term loss	62.53
Alternative tax	\$ 35,246.23

[13]

EXHIBIT "B"

Page No. 1

**Treasury Department
Internal Revenue Service
San Francisco, Calif.**

Office of:

**Internal Revenue Agent in Charge
San Francisco Division**

July 19, 1940

**Rollo C. Wheeler,
c/o Vincent H. O'Donnell
1820 Mills Tower
San Francisco, Calif.**

Re: Liquidation of John H. Wheeler Co.

Dear Sir:

An analysis of the corporation returns of the John H. Wheeler Company filed for the years 1925 to 1938, inclusive discloses that there is a substantial amount of actual net income accumulated by the corporation at Nov. 30, 1938, as indicated by the enclosed computation. Section 112(b)(7)(E) (i) of the Revenue Act of 1938 provides that there shall be taxed as a dividend to each shareholder his ratable share of the accumulated earnings and profits.

A copy of this letter is being mailed to Mr. John D. Brethauer. Kindly contact me as soon as possible so that we may arrange an appointment to verify the enclosed computation and determine the

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Elliott H. Wheeler et al vs.

correct deficiency against the 1938 return of John
H. Wheeler, Deceased.

Very truly yours,
J. GOLDBERG

Internal Revenue Agent

Enc.

G:B [14]

Commissioner of Internal Revenue

17.

JOHN H. WHEELER CO.

Computation of earnings and profits accumulated

(1) Year	(2) Net Income per return	(3) Add back dividends received, deducted on return	(4) Plus or minus, except inc. or non-deductible expense	(5) Minus capital loss (based on COST) in excess of \$1,000.00	(6) Actual earnings and profits	(7) (Memo. of capital losses on books due to INFLATION over costs to stock- holders
1925						
1926	(1,380.33)	3,968.50			2,588.17	
1927	(616.74)	11,830.54			11,213.80	
	Adj. 3,500.00				3,500.00	
1928	(279.85)	27,568.61			27,288.76	
1929	(47.50)	31,717.33			31,669.83	
	Adj. (7.08)				(7.08)	
1930	(53.10)	34,048.73			33,995.63	
	Adj. (13.43)				(13.43)	
1931	(12,218.09)	31,287.34			19,069.25	21,591.50
1932	(15,299.88)	16,726.22			1,426.34	1,149.13
1933	(16,085.55)	12,039.75			(4,045.80)	155,911.86

Computation of earnings and profits accumulated

(1) Year	(2) Net Income per return	(3) Add back dividends received, deducted on return	(4) Plus or minus, exempt inc. or non-deductible expense	(5) Minus capital-loss based on CREST in excess of \$2,000.00	(6) Actual earnings and profits	(7) Memo of capital losses on books due to INFLATION over costs to stock holders
1934	(2,273.49)	15,173.75		(10,784.85)	2,115.41	
1935	(2,902.51)	18,724.42	1,231.59	(15,918.53)	1,134.97	
	Adj. 1,924.10				1,924.10	
1936	31,281.07		(33.09)	(796.98)	30,421.00	
1937	34,630.42		1.75	(36.84)	34,595.33	662.50
1938	17,158.42		(280.47)	(15.98)	16,901.97	
(to 11/30)						
Totals	37,316.46	203,085.19	929.78	(27,553.18)	\$213,778.25	\$179,314.99
Less dividends paid:						
In 1936				\$30,465.41		
In 1937				34,469.67		
In 1938 (to 11/30)				16,917.95		
In 1938—a/c liquidation				111.84		
					81,964.87	
Balance of Accumulated Earnings and Profits					\$131,813.38	

Note: See next sheet for reconciliation of \$131,813.38 accumulated earnings and profits, as computed above, with books of the John H. Wheeler Company.

Commissioner of Internal Revenue

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Page No. 3

JOHN H. WHEELER CO.

Reconciliation of accumulated earnings and profits with books
of the John H. Wheeler Company—November 30, 1938

Capital losses on corporation's books due to Inflation
over cost to stockholders of certain securities
turned in by said stockholders for which they re-
ceived shares of stock of the John H. Wheeler Co.
based on the fair market value, when turned in,
of said certain securities. (See column 7 above)...\$179,314.99
Deficit Account on books of the John H. Wheeler
Co. (This deficit account has been charged with
the above inflated losses of \$179,314.99)..... 47,501.61

Elimination of the inflated charges of \$179,314.99
from the deficit account results in a surplus of...\$131,813.38

Note: Some of the items in the above computations are sub-
ject to verification and change. It appears, however, that any
changes made will be relatively nominal. [16]

EXHIBIT "C"

Page No. 1

Treasury Department
Internal Revenue Service
San Francisco, Calif.

Office of:
Int. Rev. Agent in Charge
San Francisco Division

September 4, 1940

John H. Wheeler (Decedent)
Rollo C. Wheeler, Executor of Estate
c/o Vincent H. O'Donnell
1820 Mills Tower
San Francisco, California

I enclose a copy of the report of the examina-

tion of your income tax returns for the years shown below. After consideration by this office, the following adjustment of your tax liability appears to be warranted; for the reasons stated in the report:

Year, 1938°

Deficiency \$30,695.00

If You Agree to this adjustment, the enclosed form of waiver should be executed and forwarded to this office promptly, in order to permit the early assessment of the additional tax and to stop the accumulation of interest. Such interest will cease 30 days after the receipt of the executed form, or upon the payment of the additional tax to the collector, whichever occurs first.

If you desire to make immediate payment of the additional tax without awaiting assessment, you should forward your remittance to the Collector of Internal Revenue at 235 Federal Office Building, San Francisco, enclosing this letter, or a copy thereof. Interest on the additional tax should be included in your remittance, computed at the rate of 6 percent per annum from the due date of the first installment to the date of payment.

If You Do Not Agree to the proposed adjustment, you may file a protest, executed in triplicate under oath, with this office, within 30 days from the date of this letter, stating the grounds for your exceptions. Any protest so filed will have careful consideration, and, if you so request, an opportunity for a hearing in this office, will be granted you prior to final determination of any deficiency

against you. This letter is not a final notice of deficiency, and this office will be pleased to answer any questions which may occur to you in your examination of the enclosed copy of the report.

Should you fail to pay the additional tax to the collector of internal revenue or to file with this office within the 30-day period mentioned either a waiver on the enclosed form or a written protest, final determination of your tax liability will be made and a notice of deficiency will be sent you in accordance with the provisions of law applicable to the assessment and collection of income- and profits-tax deficiencies.

Your prompt acknowledgment of the receipt of this letter and related papers upon the enclosed form will be much appreciated.

Respectfully,

(F. M. HARLESS)

Internal Revenue Agent in
Charge.

Enclosures:

Report of examination.

Form of waiver.

Form of acknowledgement. [17]

Page No. 2

Taxpayer:
John H. Wheeler
(Decedent)

Examining Officer:
Jacob Goldberg

Preliminary Statement**Table of Contents****Schedule No. 1 Block Adjustments****No. 1A Explanation of Items****No. 2 Computation of Tax****No. 2A Computation of Alternative Tax****Exhibit "A"** Computation of amount taxable as Dividends a/c liquidation of John H. Wheeler Co.

Principal changes in income as reported: Increase in dividend income; increase in farming income; disallowance of personal expense deduction.

All changes were discussed with Rollo C. Wheeler, Executor of deceased taxpayer's estate.

Taxpayer's objections: Increase in dividend income account liquidation of John H. Wheeler Co.

Books kept on cash basis.

Status and reason for exemption: Married and living with wife, who filed a separate return and claimed no exemption.

Report on wife, Frances V. Wheeler, is concurrently submitted.

SCHEDULE No. 1**Block Adjustments**

	Return	Additions To Income	Corrected
2. Dividends	\$42,101.36	\$66,406.69	\$108,508.05
4. Interest	300.00		300.00
9. Farming	8,351.68	238.02	8,589.70
10. (b) L. T. Cap. Loss (2,141.77)			(2,141.77)
12. Total Income	<u>\$48,611.27</u>		<u>\$115,255.98</u>

	Return	Additions To Income	Corrected
14. Interest	1,666.66		1,666.66
15. Taxes	4,359.71		4,359.71
18. Other Deductions,...	8,505.64	2,700.00	5,805.64
19. Total Deductions	\$14,532.01		11,832.01
20. Net Income	\$34,079.26	\$69,344.71	\$103,423.97

SCHEDULE NO. 1A

Explanation of Items

Item 2: Taxpayer owned 2459 shares of stock of the John H. Wheeler Co. which he acquired prior to December 31, 1929 in exchange (nontaxable) for securities which cost him \$152,342.24. The stockholders of the John H. Wheeler Co. elected to liquidate the Corporation during the month of December, 1938, under the provisions of Section 112(b)(7) of the Revenue Act of 1938. Taxpayer, a "qualified electing shareholder", executed and filed Form 964 whereby he elected to be taxed under the provisions of Section 112(b)(7)(E) of the Revenue Act of 1938. [18]

Page No. 3

Schedule No. 1A (Continued)

Amount taxable as dividends, as provided by Section 112(b)(7)(E)(i) of the Revenue Act of 1938, per Ex. "A" of this report	\$66,406.69
Amount reported as dividends on tax return.....	None
Adjustment: Addition to Income	\$66,406.69

(See item 10(b), below, for the computation of long-term capital gain under the provisions of Section 112(b)(7)(ii) of the Revenue Act of 1938)

Item 9: Taxpayer reported income on a cash basis. He apparently did not report as income when received, certificates issued by the California Prune and Apricot Growers Association. Some of these certificates were cashed in 1938, when taxpayer received \$238.02. Said \$238.02 is added to his taxable income for 1938.

Item 10(b): Re: Liquidation of John H. Wheeler Co.

Computation of long-term capital gain under the provisions of Section 112(b)(7)(E)(ii) of the Revenue Act of 1938:

Property received in liquidation 12/2/38:

Securities acquired prior to 4/9/38.....	\$311,933.06
Securities acquired after 4/9/38.....	346.94

Total securities, at fair market value, 12/2/38.....	\$312,280.00
Cash Received	55.92

Total received on liquidation	\$312,335.92
Taxpayer's basis of 2459 shares of stock of John H. Wheeler Co.	150,158.07

Gain on liquidation	\$159,177.85
Taxable as a dividend, per Exhibit A.....	66,406.69

Balance of Gain	\$ 92,771.16
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The \$92,771.16 balance of gain is recognized to the following extent:

Cash received	55.92
Securities acquired by corporation after 4/9/38.....	346.94

Long-Term Capital Gain (on Securities held for more than 24 months)\$ 402.86
Long term capital gain of \$402.86 was correctly reported on the tax return.

The basis of the securities (having a fair market value on December 2, 1938 of \$312,280.00) received in liquidation of the John H. Wheeler Co. is computed as follows, under the provisions of Section 113(a)(18) of the Revenue Act of 1938: [19]

Page No. 4

Schedule No. 1A—(Continued)

Basis of taxpayer's 2459 shares of stock of the John H. Wheeler Co.	\$153,158.07
Less: Cash received on liquidation	56.92
Remainder	\$153,102.15
Plus: Gain recognized as follows:	
Taxable as a dividend	\$ 66,406.69
Taxable as a long-term capital gain	402.86
Basis of securities acquired 12/2/38	\$219,911.70

Item 18: Included in other deductions was \$3,708.09 legal expense. Said \$3,708.09 included \$2,700.00 paid (\$1,350.00 each to Vincent H. O'Donnell and John D. Brethauer) for legal fees in contesting a substantial alleged deficiency against taxpayer for a 1935 gift tax. The giving of a gift is a personal transaction. All expenses arising out of said gift are personal expenses which are not deductible, as provided in Section 24(a)(1) of the Revenue Act of 1938. Deduction of \$2,700.00 is accordingly disallowed.

SCHEDULE No. 2

1. Net income (from Schedule 1)	\$103,423.97
2. Less: Personal Exemption	2,500.00
4. Balance (surtax net income)	\$100,923.97
6. Earned income credit	300.00
7. Balance subject to normal tax	\$100,623.97
8. Normal tax at 4 percent	\$ 4,024.96
9. Surtax on Item 4	30,535.90
10. Total tax	34,560.86
(b) Total tax (alternative tax in case of a net long-term gain or loss) (from Schedule 2-A)	35,246.23
13. Total tax assessable	\$ 35,246.23
14. Tax previously assessed	4,551.23
15. Additional tax to be assessed	\$ 30,695.00

[20]

Page No. 5

SCHEDULE No. 2-A

Computation of Alternative Tax

1. Net Income (from Schedule 1)	\$103,423.97
Plus: Net Long-Term Loss	2,141.77
Ordinary net income	\$105,565.74
2. Less: Personal exemption	2,500.00
4. Balance (surtax net income)	\$103,065.74
6. Earned income credit	300.00
7. Balance subject to normal tax	\$102,765.74
8. Normal tax at 4 per cent	\$ 4,110.63
9. Surtax on Item 4	31,778.13
10. Partial tax	\$ 35,888.76
Minus: 30% of net long-term loss	642.53
11. Alternative Tax	\$ 35,246.23

EXHIBIT "A"

Computation of amount Taxable as Dividends, under the Provisions 112(b)(7)(E)(i) of the Revenue Act of 1938

Prior to 12/31/29 John H. Wheeler and his wife turned in securities for which they received in exchange 4918 shares of stock of the John H. Wheeler Co.; par value	\$491,800.00
(on the records of the corporation Securities a/c was debited with \$491,800.00 and Capital Stock issued a/c credited with \$491,800.00)	
The securities which were turn-in cost taxpayer and his wife (each equally)	\$304,684.49
Excess of values set up on Corp. books over transferor's cost	\$187,115.51
Deficit, as of 12/31/38, per corporation's books	47,501.61
Surplus, as of 12/31/38, based on transferor's cost	\$139,613.90
Less: Excess of corporation's book value over transferor's cost of unsold securities at liquidation of corporation in December, 1938	\$ 6,800.52
Accumulated earnings and profits of the corporation, as of December 31, 1938, applicable to 4918 shares of stock	\$132,813.38
Taxpayer's ratable share, applicable to his 2459 shares of stock:	
50% of \$132,813.38	\$ 66,406.69

[Endorsed]: U. S. B. T. A. Filed May 12, 1941.

[21]

[Title of Board and Cause.]

ANSWER

Comes now the Commissioner of Internal Revenue, respondent above named, by his attorney, J.

P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed by the above-named petitioners admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4-a to f, inclusive. Denies that the Commissioner erred as alleged in subparagraphs a to f, inclusive, of paragraph 4 of the petition. [22]

5-a. Admits that the John H. Wheeler Co. was organized in 1925 by John H. Wheeler and his wife, Frances V. Wheeler; that securities with a cost of \$304,684.49 were exchanged for 4,918 shares of capital stock of John H. Wheeler Co.; that thereafter the company had a statutory income tax basis for its assets of \$304,684.49; denies the remaining allegations contained in subparagraph a of the paragraph of the petition designated 7.

5-b. Admits that in years subsequent to organization and prior to dissolution in 1938 upon sale of securities acquired upon organization the corporation used the cost of the securities to transferors as cost basis for income tax purposes; denies the remaining allegations contained in subparagraph b of the paragraph of the petition designated 7.

5-c. Denies the allegations contained in subpara-

graph e of the paragraph of the petition designated 7.

5-d. Admits that the corporation was dissolved on December 2, 1938, under the provisions of section 112(b)(7) of the Revenue Act of 1938; denies the remaining allegations in subparagraph d of the paragraph of the petition designated 7.

5-e. Admits that no taxable dividends were reported by the stockholders of the corporation upon its dissolution; denies the remaining allegations contained in subparagraph e of the paragraph of the petition designated 7.

5-f. For lack of materiality, denies the allegations contained in subparagraph f of the paragraph of the petition [23] designated 7.

5-g and h. Denies the allegations contained in subparagraphs g and h of the paragraph of the petition designated 7.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be sustained and the petitioners' appeal denied.

(Signed) J. P. WENCHEL
T. M. M.

Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:**Alva C. Baird,****Division Counsel;****T. M. Mather,****Harry R. Horrow,****Special Attorneys,****Bureau of Internal Revenue.****HRH :sob 7/2/41****[Endorsed]: U.S.B.T.A. Filed July 8, 1941. [24]****United States Board of Tax Appeals****Docket No. 107255****Docket No. 107258****Docket No. 107260****Docket No. 107263****Docket No. 107265****ESTATE OF JOHN H. WHEELER, DE-
CEASED****CORNELIA W. GOOD****ELLIOTT H. WHEELER****FRANCES V. WHEELER****YSABEL F. BERLINER****Petitioners,****v.****COMMISSIONER OF INTERNAL REVENUE,
Respondent.****STIPULATION OF FACTS****It Is Hereby Stipulated by and between the
parties hereto through their respective attorneys**

that the following facts shall be taken to be true in the above-entitled proceedings and received as evidence therein subject to the right of either party to offer such further and additional evidence not inconsistent with or contrary to the facts herein stipulated:

1. The petitioners in Docket No. 107255 are the duly appointed, qualified and acting executors of the last will and testament of John H. Wheeler, deceased. The petitioners in Docket Nos. 107258, 107260, 107263, and 107265 are Cornelia W. Good, Elliott H. Wheeler, Frances V. Wheeler, and Isabel F. Berliner, respectively. The said decedent John H. Wheeler, [25] with Frances V. Wheeler, Elliott H. Wheeler, Cornelia W. Good, Isabel F. Berliner and Rollo C. Wheeler (who is not involved in any of these proceedings) constituted all of the stockholders of John H. Wheeler Company on December 2, 1938. On said date said persons owned the following shares of the capital stock of said corporation:

Stockholder	No. of Shares
John H. Wheeler	2,459
Frances V. Wheeler	491.8
Elliott H. Wheeler	491.8
Cornelia W. Good	491.8
Isabel F. Berliner	491.8
Rollo C. Wheeler	491.8
Total	4,918.0

2. John H. Wheeler Company was organized as a corporation under the laws of the State of California in the year 1925 by said John H.

Wheeler and Frances V. Wheeler, his wife. In the years following the organization of said company, and until the year 1929, said John H. Wheeler and Frances V. Wheeler transferred to said company securities having a cost to them of \$304,683.49, in exchange for 4,918 shares of the common capital stock of said company having a par value of \$100 per share, or an aggregate value of \$491,800. No gain or loss was recognized to said transferors or transferees for federal income tax purposes by reason of any of said exchanges. The stock in the new company was issued in accordance with an open permit from the [26] Commissioner of Corporations of the State of California, which authorized the issuance at par for cash of a total of 5,000 shares of the common capital stock of the new company, or in lieu thereof the same number of shares in exchange for listed securities if the listed securities had a fair market value on the date of the exchange of \$100 for each share of the capital stock of the new company which might be issued in exchange for them. On the dates of exchange, the securities transferred to John H. Wheeler Company for said 4,918 shares of its common capital stock had an aggregate fair market value of \$491,800. After the 4,918 shares of the common capital stock of John H. Wheeler Company had been issued, the basis of said securities in the hands of the John H. Wheeler Company for purposes of determining its federal income tax liability was \$304,684.49, but the basis of the securities shown on the books of said John H.

Wheeler Company at all times thereafter was \$491,800.

3. In computing the gain or loss realized for federal income tax purposes on the sale of the particular securities which it had acquired following its organization, John H. Wheeler Company used the cost basis of said securities to its transferors, John H. Wheeler and Frances V. Wheeler. In its books of account, said John H. Wheeler Company computed gain or loss on the sale of said particular [27] securities by using the fair market value of the securities which were transferred to the corporation by John H. Wheeler and Frances V. Wheeler as set forth above.

4. On November 30, 1938, the books of account of the John H. Wheeler Company were closed and they showed a deficit of \$47,501.61. This deficit was caused principally by losses on the sale of securities acquired by the corporation following its organization computed on the basis of the fair market value of said securities at the time that they were transferred to the John H. Wheeler Company. As of the same date the difference between the cost of said securities to the said transferors and the fair market value as of the date of the transfer to the corporation was \$180,314.99. In arriving at the deficiencies involved in these proceedings, the respondent determined that the accumulated earnings and profits of the John H. Wheeler Company as of December 2, 1938, amounted to \$132,813.38. In computing said earn-

ings and profits, respondent subtracted the said deficit of \$47,501.61 as shown on the books of John H. Wheeler Company from said sum of \$180,314.99, which respondent had computed as aforesaid.

5. After giving consideration to the application of Section 112 (b) (7) of the Revenue Act of 1938, the stockholders of the John H. Wheeler Company dissolved said corporation on December 2, 1938, and all of its assets, consisting of securities having a fair market value of \$624,560 and cash in the sum of \$111.84, were distributed in liquidation during the month of December, 1938, proportionately to the stockholders of said company.

6. The fair market value of the assets received by the stockholders of John H. Wheeler Company in said liquidation as of December 2, 1938, were as follows:

John H. Wheeler	\$312,335.92
Frances V. Wheeler	62,467.18
Elliott H. Wheeler	62,467.18
Cornelia W. Good	62,467.18
Ysabel F. Berliner	62,467.18
Rollo C. Wheeler	62,467.18

7. The basis of the stock of the John H. Wheeler Company to the said stockholders for federal income tax purposes at the time of liquidation was as follows:

John H. Wheeler	\$153,505.01
Frances V. Wheeler	30,701.00
Elliott H. Wheeler	30,701.00
Cornelia W. Good	30,701.00

Ysabel F. Berliner	30,701.00
Rollo C. Wheeler	30,701.00
	<hr/>
	\$305,610.01

8. Pursuant to the provisions of Section 112 (b) (7) of the Revenue Act of 1938, John H. Wheeler, Frances V. Wheeler, Elliott H. Wheeler, Cornelia W. Good, and Ysabel F. Berliner [29] executed written elections on Form 964 to have recognized and taxed in accordance with Section 112 (b) (7) of the Revenue Act of 1938 the gains on the shares of the capital stock of the John H. Wheeler Company owned by them on December 2, 1938. John H. Wheeler, Frances V. Wheeler, Elliott H. Wheeler, Cornelia W. Good, and Ysabel F. Berliner, in filing their federal income tax returns for the year 1938, reported as long-term capital gains their proportionate share of the securities acquired by the John H. Wheeler Company after April 9, 1938, and the cash which was distributed in liquidation as follows:

John H. Wheeler	\$402.86
Frances V. Wheeler	80.57
Elliott H. Wheeler	80.57
Cornelia W. Good	80.57
Ysabel F. Berliner	80.57

9. Said John H. Wheeler and the other petitioners herein did not report in their federal income tax returns for the year 1938 any dividends as having been received by them in connection with the liquidation of said John H. Wheeler Company, but did file said written elections on Form 964, or in accordance with Section 112 (b) (7) (E) of

the Revenue Act of 1938. Said John H. Wheeler died on June 14, 1939, and a deficiency in tax was asserted by the respondent on or about February 12, 1941, against the executors of his estate and each of the other petitioners in the following amounts: [30]

Estate of John H. Wheeler.....	\$30,695.00
Frances V. Wheeler	2,682.95
Elliott H. Wheeler	2,138.67
Cornelia W. Good	1,662.71
Ysabel F. Berliner	1,474.27

10. In arriving at the deficiencies involved in these proceedings, the respondent included in the net income of John H. Wheeler and each of the other petitioners for the year 1938 dividends representing their proportionate share of the accumulated earnings and profits of the company, and computed said earnings and profits in the manner outlined in paragraph 4 above. The amounts of the dividends which respondent determined were distributed by said company in liquidation under the provisions of Section 112 (b) (7) of the Revenue Act of 1938 are as follows:

John H. Wheeler	\$66,406.69
Frances V. Wheeler	13,281.38
Elliott H. Wheeler	13,281.38
Cornelia W. Good	13,281.38
Ysabel F. Berliner	13,281.38

The petitioners' computation of earnings and profits differs from that of respondent in that petitioners assert that the cost of the securities transferred to the John H. Wheeler Company in ex-

change for its capital stock was the fair market value thereof on the date of transfer to the company, without regard to the cost of said securities to the transferors. [31]

11. In arriving at the deficiencies asserted against the petitioners, the respondent did not reduce the accumulated earnings and profits determined to have been distributed to said stockholders by the amount of the deficiency in income tax of the John H. Wheeler Company for 1936 in the amount of \$5,953.06. The respondent has determined that the stockholders are liable for said deficiency as transferees of the assets of the John H. Wheeler Company, and the proceedings involving said transferees' liability are now pending before the Board of Tax Appeals as Docket Nos. 107256, 107257, 107259, 107261, 107262, and 107264.

12. No claim is made by the respondent that the proceedings taken by the John H. Wheeler Company and its stockholders to dissolve the John H. Wheeler Company and distribute its assets under Section 112 (b) (7) of the Revenue Act of 1938 were defective or incomplete.

Dated: This 27th day of March, 1942.

VINCENT H. O'DONNELL

Counsel for Petitioners

1820 Mills Tower

San Francisco, Calif.

J. P. WENCHEL

Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent [32]

**ORAL STIPULATION READ INTO THE
RECORD OF MARCH 28, 1942.**

Mr. O'Donnell: At this time I would like to offer in evidence a copy of a tax return for the year 1938, which reports the income taxes for the John H. Wheeler Company for the year 1938, and I will ask counsel for the Respondent to stipulate with me that this copy of the return for the year 1938, covering the income of the John H. Wheeler Company is true and correct, and an exact copy of the return, the original return being in the Respondent's possession.

Mr. Horrow: So stipulated.

The Clerk: Exhibit 1.

The Member: It will be received in evidence as Petitioners' Exhibit 1.

(The copy of income tax return, marked Petitioners' Exhibit No. 1, was received in evidence)

Mr. O'Donnell: So there will be no misunderstanding, the stipulation just made as to Exhibit No. 1 is understood to run to the first group of cases, that is, cases 107255, 107258, 107260, 107263 and 107265.

Any further stipulation will run to that group of cases unless counsel otherwise indicates.

Mr. Horrow: Correct.

Mr. L'Donnell: I now offer in evidence a copy of income tax return for the calendar year 1938, on Form 1120-H, for the John H. Wheeler Company, and offer to stipulate that this return is an

exact copy of the original return filed by the John H. Wheeler Company in March of 1939, and an exact copy of the original in the possession of [33] the Respondent.

Mr. Horrow: So stipulated.

The Clerk: Exhibit 2.

The Member: It will be received in evidence as Petitioners' Exhibit No. 2.

(The copy of income tax return, marked Petitioners' Exhibit No. 2, was received in evidence)

Mr. O'Donnell: That completes the evidence in this first group of cases.

Mr. Horrow: I think that completes the record, your Honor.

[Endorsed]: U.S.B.T.A. Filed 4-20-42. [34]

Treasury Department

FORM 201A

Internal Revenue Service

1938

UNITED STATES

CORPORATION INCOME AND EXCESS-PROFITS TAX RETURN 1938

For corporations having total receipts of not more than \$100,000 and a net income of not more than \$25,000, or for corporations having total receipts of not more than \$100,000 and a net income of not more than \$25,000, or for corporations having total receipts of not more than \$100,000 and a net income of not more than \$25,000.

For Calendar Year 1938

or fiscal year beginning

1938 and ending

1939 DUPLICATE COPY

IMPORTANT

One duplicate copy must be made









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QUESTIONS

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QUESTIONS



Petitioners' Exhibit No. 1—(Continued)

John H. Wheeler Co.
St. Helena, California

INVESTMENTS IN STOCKS AND 1938
DIVIDENDS RECEIVED

Shares		Cost to Corporation	1938 Dividends
240	American Smelting & Ref.....	\$ 12,882.30	\$ 420.00
60	American Car & Foundry	1,432.50	
340	American Tel. & Tel. Co.....	37,519.60	3,033.00
10	Armour of Del. 7% Pfd.	870.00	105.00
50	Boeing Airplane	1,200.19	
500	Caterpillar Tractor Co. Com.....	18,465.93	1,018.75
100	Cerro de Pasco Copper Corp.....	6,112.50	400.00
900	Consol. Chem. Ind. "A"	20,560.00	1,357.50
90	Crown Zellerbach Pfd 5%.....	7,521.88	450.00
120	Crown Zellerbach Common	250.42	86.26
140	Douglas Aircraft Co.	6,846.10	420.00
20	Dow Chemical Co.	2,078.00	60.00
450	DuPont de Nemours & Co.....	34,670.28	791.00
30	Eastman Kodak Co. of N. J.....	4,895.65	195.00
410	Electric Bond & Share	5,117.98	
50	Fibreboard Products Prior Pfd.....	5,086.67	300.00
2540	General Electric Co.	50,348.70	1,780.80
800	General Motors Corp.	15,228.75	600.00
100	Goodyear Pfd. 5%	8,685.84	375.00
50	International Harvester Co.	2,825.00	107.50
700	Kennicott Copper Corp.	14,017.50	525.00
50	Loew's Inc. Pfd.	5,015.63	325.00
80	McKesson & Robbins Pfd. #3.....	1,309.41	168.75
30	Montgomery Ward & Co.....	1,445.80	52.50
300	National Auto Fibres "A"	2,501.94	
40	Ohio Oil Pfd. 6%	4,408.00	270.00
80	Owens Illinois Glass Co.....	5,608.66	126.00
50	Pacific Lighting Corp. Com.....	2,893.75	150.00
440	Paraffine Co's	14,498.78	667.50
110	Pure Oil Pfd. 6%	9,098.99	708.00
50	Pan American Airways	1,457.70	50.00
1000	Radio Corp. of America	4,825.00	
40	Sherwin Williams Co.	5,434.50	100.00
1820	Socony Vacuum Oil Co.	29,575.00	912.00
100	Standard Oil of Calif.	4,320.00	105.00

Petitioners' Exhibit No. 1—(Continued)

Shares		Cost to Corporation	1933 Dividends
450	Standard Oil of Indiana	12,150.00	337.50
20	Standard Oil of New Jersey	1,267.48	25.00
800	Texas Gulf Sulphur Co.	37,450.00	1,200.00
10	Tidewater Assoc. Pfd. 4½	142.50	63.00
200	United Aircraft Corp.	3,848.88	100.00
150	United Air Lines Transport	2,211.18	
100	U. S. Rubber 1st Pfd 8%	10,800.00	
100	U. S. Steel Corp.	8,304.98	
500	Westinghouse Elect & Mfg Co.	19,123.02	1,255.00
Total		\$444,588.39	\$18,640.00

[39]

Petitioners' Exhibit No. 1—(Continued)

JOHN H. WHEELER CO.
St. Helena, California

TAX RETURN SCHEDULE—YEAR 1938

Schedule "C"

Capital Gains & Losses

	Acquired	Sold	Sales Price	Cost	Gain
15 Sh Caterpillar		5-16-38	\$ 1,529.21	\$ 1,500.00	\$ 29.21
5 M U. S. Treas. Bonds		5-16-38	5,464.76	5,263.13	211.63
113 Sh Consol Chem "A"		6-14-38	2,652.57	2,260.00	392.57
6 Sh Consol Chem "A"		6-14-38	2.87		2.27
5 Sh Armour of Del 7%	1-1-23	11-18-38	514.37	495.70	18.67
2 Sh Dupont			288.75	154.10	134.65
4 Sh General Electric			175.00	79.48	95.72
5 Sh Montg. Ward			248.75	240.95	7.80
2 Sh Ohio Oil Pfd 6%			223.50	220.00	3.50
4 Sh Owens Ill Glass			283.00	280.44	2.56
5 Sh Paraffine Co's			290.62	164.75	125.87
8 Sh Pure Oil Pfd 6%			704.00	661.76	42.24
4 Sh Tidewater Oil Pfd	7-25-27		366.00	57.00	309.00
2 Sh Westinghouse			283.50	76.48	157.02

Total Gains.....

\$1,592.71

Petitioners' Exhibit No. 1—(Continued)

Tax Return Schedule—Year 1938—(Continued)

Schedule "C"	Capital Gains & Losses	Acquired	Sold	Sales Price	Cost	Losses
10 Sh Consol Chem "A"			6-14-38	\$ 235.00	322.50	\$ 87.50
5 Sh Electric Bond			11-18-38	55.00	62.40	7.40
4 Sh Socony Vacuum				52.00	65.00	13.00
5 Sh Stand. Oil N. J.				280.62	316.90	56.28
Total Losses						\$ 164.18
Total				\$13,576.92	\$12,210.39	\$ 1,368.53
Plus unallowable deductions Sec. 24(b)						76.68
Total Taxable Capital Gain						\$ 1,445.21

Form 1120 A
Year 1938

[40]

Petitioners' Exhibit No. 1—(Continued)

JOHN H. WHEELER CO.

St. Helena, California

A corporate liquidation in December 1938 under Section 112(b)(7):

John H. Wheeler Co.

St. Helena, Calif.

Incorporated under laws of State of California, October 9, 1925.

Adopted a plan of complete liquidation on December 2, 1938 providing for a distribution in complete cancellation or redemption of all its stock, and for the transfer of all its property under the liquidation entirely within the month of December 1938.

Last income tax return was filed with the Collector of Internal Revenue at San Francisco for the year 1937.

Capital Stock outstanding on date of adoption of plan of liquidation, 4918 shares of common stock with one vote per share.

List of Shareholders on date of adoption of Plan:

John H. Wheeler	2459	Sh	#37	2459	Votes	50%
Francis V. Wheeler	491-4/5	Sh	36	491-4/5	Votes	10
Elliott H. Wheeler	491-4/5	Sh	30	491-4/5	Votes	10
Cornelia W. Good	491-4/5	Sh	32	491-4/5	Votes	10
Isabel F. Berliner	491-4/5	Sh	28	491-4/5	Votes	10
Rollo C. Wheeler	491-4/5	Sh	34	491-4/5	Votes	10
Total	4918	Sh		4918	Votes	100%

List of Shareholders on April 9, 1938:

Transfers

John H. Wheeler	2459	Sh	Var		
Frances V. Wheeler	459	Sh	Var	Plus	32-4/5
Elliott H. Wheeler	500	Sh	#24	Minus	8-1/5
Cornelia W. Good	500	Sh	#25	Minus	8-1/5
Isabel F. Berliner	500	Sh	#23	Minus	8-1/5
Rollo C. Wheeler	500	Sh	#26	Minus	8-1/5
Total	4918	Sh			

Elliott H. Wheeler, Cornelia W. Good, Isabel F. Berliner and Rollo C. Wheeler each transferred 8-1/5 shares to Frances V. Wheeler in order to give each of the shareholders involved an even 10% interest in John H. Wheeler Co. which would simplify the distribution of the assets of John H. Wheeler Co.

Petitioners' Exhibit No. 1—(Continued)

JOHN H. WHEELER CO.

St. Helena, California

DISTRIBUTION IN LIQUIDATION OF

JOHN H. WHEELER CO.

Securities acquired prior to April 9, 1938.....\$623,866.13

Securities acquired after April 9, 1938:

5 Sh Crown Zellerbach\$ 63.75

3 Sh American Tel & Tel..... 445.12

5 Sh McKesson & Robbins 185.00

693.87

Total Securities Distributed Dec. 2, 1938.....\$624,560.00

Cash Distributed 111.84

Total Distributed in liquidation.....\$624,671.84

Cost of John H. Wheeler Co. Stock to Shareholders:

1927 and prior..... 4278 Sh.....\$240,684.49

1929..... 640 Sh..... 64,000.00

1934 Taxable dividend not withdrawn 1,631.66

Total Cost of 4918 Sh @ 62.43.....\$306,316.15

Excess to shareholders on basis market
value over cost\$318,355.69

BASIS FOR DEFERRED GAIN:

Cost of stock redeemed\$306,316.15

Less Money received in liquidation..... 111.84

Remainder\$306,204.31

Plus gain recognized

On cash received\$111.84

On securities after Apr. 9, 1938..... 693.87

805.71

Basis of property acquired\$307,010.02

Apportioned to securities distributed

307,010.02 cost or basis

624,560.00 market equals 49156209 of market

Petitioners' Exhibit No. 1—(Continued)

Distributed to		Basis	Value	Excess
John H. Wheeler	50%	\$153,505.01	\$312,280.00	\$158,774.99
Francis V. Wheeler	10	30,701.00	62,456.00	31,755.00
Elliott H. Wheeler	10	30,701.00	62,456.00	31,755.00
Cornelia W. Good	10	30,701.00	62,456.00	31,755.00
Isabel F. Berliner	10	30,701.00	62,456.00	31,755.00
Rollo C. Wheeler	10	30,701.01	62,456.00	31,754.99
Total	100%	\$307,010.02	\$624,560.00	\$317,549.98

[42]

JOHN H. WHEELER CO.
St. Helena, California

STOCKS DISTRIBUTED IN LIQUIDATION

Shares		Dec. 2, 1938 Market Value	42152389 Basis to Shareholders
240	American Smelting	\$ 12,180.00	\$ 5,987.23
60	American Car & Foundry Co.....	1,710.00	840.57
340	American Tel & Tel.....	50,477.50	24,812.83
10	Armour of Del. 7% Pfd.....	1,025.00	503.85
50	Boeing Airplane	1,543.75	758.85
500	Caterpillar Tractor Co. Com.....	22,937.50	11,275.21
100	Cerro de Pasco Copper Corp.....	4,587.50	2,255.04
900	Consol. Chem. Ind. "A"	20,700.00	10,175.34
90	Crown Zellerbach Pfd. 5%.....	8,055.00	3,959.53
120	Crown Zellerbach Common	1,530.00	752.09
140	Douglas Aircraft Co.	9,572.50	4,705.48
20	Dow Chemical Co.	2,650.00	1,302.64
450	DuPont de Nemours & Co.....	65,081.25	31,991.48
30	Eastman Kodak Co. of New Jersey	5,362.50	2,636.00
410	Electric Bond & Share	4,151.25	2,040.60
50	Fibreboard Products Prior Pfd.	5,250.00	2,580.70
2540	General Electric Company	104,775.00	51,503.42
800	General Motors Corp.	38,400.00	18,875.98
100	Goodyear Pfd. 5%	10,100.00	4,964.78
50	International Harvester Co.....	2,968.75	1,459.32
700	Kennicott Copper Corp.	30,275.00	14,882.04
50	Loew's Inc. Pfd.	5,406.25	2,657.51
80	McKesson & Robbins Pfd \$3.....	2,960.00	1,455.02
30	Montgomery Ward & Co.....	1,451.25	713.38

Petitioners' Exhibit No. 1—(Continued)

Shares		Dec. 1, 1933 Market Value	49156399 Basic to Shareholders
300	National Auto-Fibres "A"	2,437.50	1,198.18
40	Ohio Oil Pfd. 6%	4,410.00	2,167.79
80	Owens Illinois Glass Co.	5,480.00	2,693.76
50	Pacific Lighting Corp. Common..	2,000.00	983.12
440	Paraffine Co's	24,860.00	12,220.23
110	Pure Oil Pfd 6%	9,460.00	4,650.18
50	Pan American Airways	868.75	427.04
1000	Radio Corp. of America	7,500.00	3,686.72
40	Sherwin Williams Co.	4,095.00	2,012.95
1820	Socony Vacuum Oil Co.	24,797.50	12,189.51
100	Standard Oil Co. of Calif.	2,687.50	1,321.07
450	Standard Oil Co. of Indiana	12,262.50	6,027.78
20	Standard Oil Co. of New Jersey	1,012.50	497.71
800	Texas Gulf Sulphur Co.	25,500.00	12,534.83
10	Tidewater Assoc. Pfd. 4½%	920.00	452.24
200	United Aircraft Corp.	7,400.00	3,637.56
150	United Air Lines Transport.	1,743.75	857.16
100	U. S. Rubber 1st Pfd. 8%	10,425.00	5,124.53
100	U. S. Steel Corp.	6,237.50	3,066.12
500	Westinghouse Electric Mfg. Co..	57,312.50	28,172.65
Total		\$624,560.00	\$307,010.02
		Per Share	62.4258

[Endorsed]: U.S.B.T.A. Filed Mar. 28, 1942.

[43].

Form 1120-11

Internal Revenue Service

UNITED STATES

1938 RETURN OF PERSONAL HOLDING COMPANY 1938

For Calendar Year 1938

DUPLICATE COPY

IMPORTANT

The duplicate copy must be
submitted with original return.
If original return is lost, duplicate

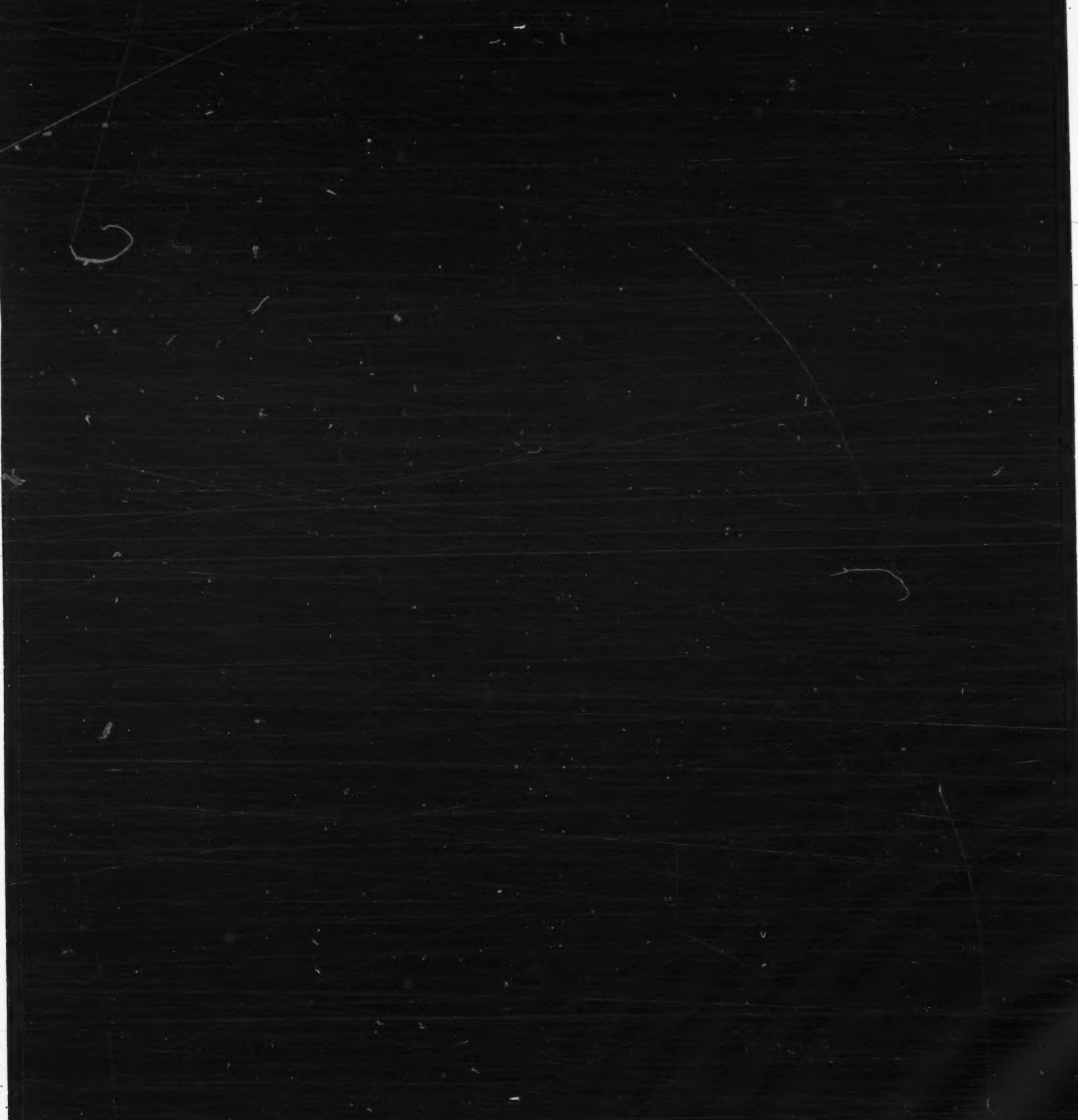




INSTRUCTIONS FOR FORM 1120H
1938 UNITED STATES RETURN OF PERSONAL HOLDING COMPANY 1938

Read the General Instructions, A, for Line 1, before entering any figures in their returns and to
be sure that they are in the items to which they refer.

GENERAL INSTRUCTIONS



SPECIFIC INSTRUCTIONS

The Tax Court of the United States

Docket Nos. 107255, 107258, 107260, 107263, 107265.

**ESTATE OF JOHN H. WHEELER, DE-
CEASED, ELLIOTT H. WHEELER AND
ROLLO C. WHEELER, EXECUTORS,**

'Petitioners, et al.,'¹

v.

**COMMISSIONER OF INTERNAL REVENUE,
Respondent.**

Promulgated February 24, 1943.

1. A personal holding corporation issued its outstanding stock in exchange for certain securities transferred to it by two of its stockholders. In 1938 its stockholders elected to liquidate under section 112 (b) (7) of the Revenue Act of 1938, under which, inter alia, that portion of the gain realized by each stockholder on liquidation not in excess of his ratable share of the earnings and profits of the corporation is recognizable and taxable as a dividend. In computing gain or loss for income tax purposes on the sale of such securities the corporation used its transferors' basis, but in computing earnings and profits as shown by its books of account and for the purpose of

¹Proceedings of the following petitioners are consolidated herewith: Cornelia W. Good; Elliott H. Wheeler; Frances V. Wheeler; and Ysabel F. Berliner.

section 112 (b) (7) it used as a basis the fair market value of the securities at the time of exchange. The respondent used the transferors' basis, as provided in section 501 (a), Second Revenue Act of 1940, in computing earnings and profits under section 112 (b) (7), 1938 Act. Held, that the provisions of said section 501 (a) are applicable and respondent's determination is approved.

2. Section 501 (a), Second Revenue Act of 1940, applied to a liquidation completed in 1938, is not violative of the Fifth Amendment of the Federal Constitution as being confiscatory in effect.

3. In computing earnings and profits a 1936 surtax on undistributed profits is deductible, notwithstanding the corporation used the cash basis and the tax was not paid in 1936. *H. M. Alworth Trust*, 46 B. T. A. 1045, followed.

Vincent H. O'Donnell, Esq., for the petitioners.
Harry R. Horrow, Esq., for the respondent.

OPINION.

Arnold, Judge: These consolidated proceedings involve deficiencies in income tax for the year 1938 as follows:

Docket No. 107255.....	\$30,695.00
Docket No. 107258.....	1,662.71
Docket No. 107260.....	2,138.67
Docket No. 107263.....	2,682.95

The questions involved are (1) whether the respondent erred in applying the provisions of section 501 (a) of the Second Revenue Act of 1940 in computing "earnings and profits" distributed in liquidation by the John H. Wheeler Co. to its stockholders under section 112 (b) (7) of the Revenue Act of 1938, (2) whether section 501 (a) of the Second Revenue Act of 1940 so applied is constitutional, and (3) whether respondent erred in failing to reduce the amount of earnings and profits determined by him by \$5,953.06, the amount of the deficiency in surtax on undistributed profits for 1936 determined by the respondent against the John H. Wheeler Co. The proceedings were submitted upon a stipulation of facts and two exhibits. The facts as stipulated are adopted as our findings of fact. We state herein only such as are deemed necessary to an understanding of the issues involved.

The petitioners, Elliott H. Wheeler and Rollo C. Wheeler, in Docket No. 107255 are the duly appointed and acting executors of the last will and testament of John H. Wheeler, who died on June 14, 1939, hereinafter referred to as the decedent. All returns involved herein were filed with the collector of internal revenue for the first district of California. On December 2, 1938, the decedent, Frances V. Wheeler, Elliott H. Wheeler, Cornelia W. Good, Ysabel F. Berliner, and Rollo C. Wheeler (the latter not being involved in any of these proceedings) were the holders of all of the outstanding shares of the stock of the John H. Wheeler Co.,

hereinafter referred to as the Wheeler Co., as follows:

Shares held		Shares held	
John H. Wheeler.....	2,459	Ysabel F. Berliner.....	491.8
Frances V. Wheeler.....	491.8	Rollo C. Wheeler	491.8
Elliott H. Wheeler.....	491.8		
Cornelia W. Good.....	491.8	Total.....	4,918.0

The Wheeler Co. was organized as a corporation under the laws of the State of California in 1925 by the decedent and his wife, Frances V. Wheeler. In the years following its organization and until 1929 the decedent and his wife transferred to the company securities having a cost to them of \$304,683.49, in exchange for 4,918 shares of the common capital stock of the company having a par value of \$100 a share, or an aggregate par value of \$491,800. No gain or loss was recognized to the transferors or transferees for Federal income tax purposes by reason of any of such exchanges. On the dates of exchange, the securities transferred to the Wheeler Co. for the 4,918 shares of its common stock had an aggregate fair market value of \$491,800. The basis of the securities for the purpose of determining the Federal income tax liability of the Wheeler Co. was \$304,684.49, but the basis of the securities set up and entered on the books of account of the company was \$491,800. [49]

In computing the gain or loss realized on sales by the Wheeler Co. of the above securities for Federal income tax purposes the Wheeler Co. used the cost basis of the securities to its transferors, the decedent and his wife. In computing the gain or loss on sales

by the Wheeler Co. of such securities, as shown by its books of account and as reflected in its earnings and profits account, the Wheeler Co. used the fair market value of the securities as of the dates of transfer to it. On November 30, 1938, the books of account of the Wheeler Co. were closed and showed a deficit of \$47,501.61. This deficit was caused principally by losses on sales by the Wheeler Co. of securities transferred by decedent and his wife to the company, computed on the basis of their book or fair market value at the time of their transfer to the Wheeler Co. by decedent and his wife.

After giving consideration to the application of section 112 (b) (7) of the Revenue Act of 1938,²

²SEC. 112. RECOGNITION OF GAIN OR LOSS.

(b) Exchanges Solely in Kind.—

(7) Election as to Recognition of Gain in Certain Corporate Liquidations.—

(A) General Rule.—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before, or after January 1, 1938; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December, 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized

the Wheeler Co. was dissolved on December 2, 1938, and all of its assets, consisting of securities having a fair market value of \$624,560 and cash in the sum of \$111.84, were distributed in liquidation, during December 1938, proportionately to the stockholders of the company. At the time of dissolution substantially all the securities originally acquired from John H. Wheeler and Frances V. Wheeler had been sold by the Wheeler Co. The fair market value of the assets of the Wheeler Co. received by its stockholders in liquidation as of December 2, 1938, and

only to the extent provided in subparagraphs (E) and (F).

.

(C) **Qualified Electing Shareholders.**—The term “qualified electing shareholder” means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D), but—

(i) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 percentum of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; or

.

(D) **Making and Filing of Elections.**—The written elections referred to in subparagraph (C) must be made and filed in such manner as to be not in

the basis of the stock of the Wheeler Co. to each stockholder for Federal income tax purposes at the time of liquidation are as follows:

Stockholders	Fair market value as of Dec. 2, 1938	Basis of Wheeler Co. stock
John H. Wheeler	\$312,335.92	\$153,505.01
Frances V. Wheeler	62,467.18	30,701.00
Elliott H. Wheeler	62,467.18	30,701.00
Cornelia W. Good	62,467.18	30,701.00
Ysabel F. Berliner	62,467.18	30,701.00
Rollo C. Wheeler	62,467.18	30,701.00

[50]

Pursuant to the provisions of section 112 (b) (7)

contravention of regulations prescribed by the Commissioner with the approval of the Secretary. The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) **Noncorporate Shareholders.**—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938; and

(ii) There shall be recognized, and taxed as a short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

the decedent and other petitioners herein executed written elections on Form 964 to have the gains on the shares of stock of the Wheeler Co. owned by them on December 2, 1938, recognized and taxed in accordance with section 112 (b) (7).

The decedent and other petitioners herein each reported as a long term capital gain in their respective 1938 Federal income tax returns only the value of their proportionate share of the securities acquired by the Wheeler Co., after April 9, 1938, and the proportionate amount of cash which was distributed in liquidation to each as follows:

John H. Wheeler	\$402.86
Frances V. Wheeler	80.57
Elliott H. Wheeler	80.57
Cornelia W. Good	80.57
Ysabel F. Berliner	80.57

The respondent determined that the Wheeler Co. had accumulated earnings and profits of \$132,813.38 as of December 2, 1938, and that the gain realized by each petitioner was recognizable in addition to the amount reported to the extent of his ratable share thereof under section 112 (b) (7) as follows:

John H. Wheeler	\$66,406.69
Frances V. Wheeler	13,281.38
Elliott H. Wheeler	13,281.38
Cornelia W. Good	13,281.38
Ysabel F. Berliner	13,281.38

[51]

The amount of accumulated earnings and profits of the Wheeler Co. was determined by the respondent as follows:—

Fair market value of 4,918 shares of Wheeler Co. stock or fair market value of securities exchanged therefor, set up on corporate books as cost of securities	\$491,800.00
Cost of securities to decedent and wife transferred by them to Wheeler Co. for its stock.....	304,684.49
Excess of corporate book value over transferors' cost	187,115.51
Less deficit on corporate books as of December 31, 1938	47,501.61
Surplus as of December 31, 1938 based on transferors' cost	139,613.90
Less excess of book value over transferors' cost of securities unsold at liquidation of Wheeler Co.....	6,800.52
Accumulated earnings and profits as of December 31, 1938 available for distribution to 4,918 shares of stock	132,813.38

The petitioners' computation of earnings and profits of Wheeler Co. differs from that of respondent in that petitioners assert that the cost to the company of the securities transferred to it in exchange for its 4,918 shares of stock is the fair market value of the securities on the date of transfer, and not the cost of the securities to the transferors as used by respondent in his computation of the deficiencies.

In the income tax return of the Wheeler Co. for 1938 it is stated that the return was made on the basis of cash receipts and disbursements.

Section 112 (b) (7) (E) (i) provides that upon complete liquidation of a domestic corporation under subsection (7) there shall be recognized and taxed as a dividend to the noncorporate shareholders the ratable share of the "earnings and profits"

of the corporation accumulated after February 28, 1913. The respondent contends that the "earnings and profits" distributed in liquidation by the Wheeler Co. and taxable to petitioners as dividends should be computed by applying the provisions of section 501 (a) of the Second Revenue Act of 1940, which so far as applicable herein is set forth in the margin.³ [52]

³SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) Under Internal Revenue Code.—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(1) **Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.**—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis

The petitioners contend that the "earnings and profits" of the Wheeler Co. for the purposes of section 112 (b) (7) should be computed in accordance with the rules established by decisions of the courts and the Board which hold that "taxable income" is not the equivalent of "earnings and profits," and that on the disposition by a corporation of property acquired by it in exchange for its stock in a transaction wherein gain is not recognizable for the purposes of computing "taxable income," the basis of such property to the corporation for the purpose of determining "earnings and profits" available for the distribution of dividends is the cost of the property to the corporation or its fair market value at the time of the exchange, although the basis for the determination of taxable income on the same trans-

used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. * * *"

• • • • •

▲ (b) **Effective Date of Amendment.**—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) **Under Prior Acts.**—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

action is cost to the transferor of the property. In support of this contention petitioners cite Charles F. Ayer, 12 B. T. A. 284; Ida I. McKinney, 32 B. T. A. 450; *affd.*, 87 Fed. (2d) 811; Susan T. Freshman, 33 B. T. A. 394; R. M. Weyerhaeuser, 33 B. T. A. 594; Robert R. McCormick, Executor, 33 B. T. A. 1046; Helen Sperry Lea, 35 B. T. A. 243 (*reversed* 96 Fed. (2d) 55, on the ground that transaction was a nontaxable reorganization under section 112 (i) (1) (B) (g), Revenue Act of 1938); F. J. Young Corporation, 35 B. T. A. 860; *affd.*, Fed. (2d) 137; W. S. Farish & Co., 38 B. T. A. 150; *affd.*, 104 Fed. (2d) 833; W. & K. Holding Co., 38 B. T. A. 830; A. & J., Inc., 38 B. T. A. 1248; and Dorothy Whitney Elmhirst, 41 B. T. A. 348. The petitioners further contend that section 501 of the Second Revenue Act of 1940, if properly construed, is not applicable to voluntary liquidation and dissolution of a corporation commenced and completed in 1938, but if it is construed to be applicable to a liquidation completed in 1938, such construction violates the rule of "permissible retroactivity" and that therefore section 501 is unconstitutional as in violation of the due process clause of the Fifth Amendment to the Constitution of the United States. [53]

The respondent contends that, while some of the decisions cited by petitioners had been handed down prior to the liquidation of the Wheeler Co., nevertheless there had been no final adjudication of the proper basis to be used in determining the earnings and profits of a corporation; that article 115-3 of

Regulations 101,⁴ promulgated under the Revenue Act of 1938, providing that gains or losses should be brought into earnings and profits at the time and to the extent that gains and losses are recognized under the provisions of section 112 or corresponding provisions of prior acts, gave notice to the taxpayers that the Commissioner maintained his position despite the decisions of the Board and the Circuit Courts; that Congress resolved the question by enacting section 501 of the Second Revenue Act of 1940; and that its applicability to the Revenue Act of 1938 is not unconstitutional.

Art. 115-3. Earnings or Profits.—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

[Similar provisions are contained in art. 115-3, Regulations 101, 1938 Act, and Regulations 94, 1936 Act, and art. 115-1, Regulations 86, 1934 Act.]

Section 501 of the Second Revenue Act of 1940 is a complete answer to petitioners' contention as to what constitutes earnings and profits of a corporation in liquidation if it is applicable to the liquidation here in 1938 and is not in violation of the due process clause of the Fifth Amendment to the Constitution.

That Congress clearly intended the section to apply to transactions in prior years admits of no doubt. Subsection (c) thereof specifically provides that "for the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment." There is no ambiguity in this respect. This language must be given effect in determining Congressional intent. The petitions herein were filed after September 20, 1940.

It then remains to be determined whether the amendment, applied to the liquidation in question, is in violation of the due process clause of the Fifth Amendment to the Constitution, because of its retroactive provisions. If not, then respondent's determination must be approved.

Retroactivity alone of a taxing statute is not sufficient to bring the [54] law into conflict with the Federal Constitution. *Welch v. Henry*, 305 U. S. 134; *United States v. Hudson*, 299 U. S. 498; *Cooper v. United States*, 280 U. S. 409; *Brushaber v. Union Pacific Railroad Co.*, 240 U. S. 1. In the latter case the Supreme Court held that the due process of law

clause is not a limitation upon the taxing power conferred upon Congress by the Constitution, unless, under a seeming exercise of the taxing power, the taxing statute is so arbitrary as to compel the conclusion that it is a confiscation of property rather than the levying of a tax, or so wanting in basis for classification as to produce such a gross and patent inequality as inevitably to lead to the same conclusion.

Petitioners cite and strongly rely upon *Nichols v. Coolidge*, 274 U. S. 531; *Blodgett v. Holden*, 275 U. S. 142; and *Untermeyer v. Anderson*, 276 U. S. 440, in support of their contention that the application of section 501 (a), Second Revenue Act of 1940, is arbitrary, capricious, and amounts to confiscation and therefore offends the Fifth Amendment. These cases involve gifts made prior to the enactment of the statute which sought to tax them. It was held that, as the gifts were voluntary acts not subject to tax when made and might not have been made otherwise, to tax them under a retroactive statute was violative of the Fifth Amendment. The facts here do not justify the conclusion there reached.

The liquidation of the Wheeler Co. in 1938 was not prompted by motives of unselfishness and generosity as in the case of gifts, but, in the face of mounting surtaxes on personal holding companies, it was advisable from a tax standpoint to liquidate, as will be hereinafter pointed out.

Neither is the fact that the liquidation of the Wheeler Co. was completed in 1938 prior to the en-

actment of section 501 (a) of the Second Revenue Act of 1940 sufficient to make invalid the application of the provisions thereof to the 1938 Act. It is necessary to consider the nature of the tax and the transactions involved. *Milliken v. United States*, 283 U. S. 15. In that case it was held that a statute imposing an estate transfer tax was not unconstitutional as applied to gifts in contemplation of death made before the enactment of such statute and during the existence of a prior act imposing lower rates.

The Wheeler Co. was a personal holding company, the type of corporation referred to as an "incorporated pocketbook" and "the most prevalent form of tax avoidance practiced by individuals with large incomes." Report No. 704 from Committee on Ways and Means, 73d Cong., 2d sess., p. 11. Under the Revenue Act of 1932 a corporation was required to pay a tax of $13\frac{3}{4}$ percent of its net income (sec. 13), whereas an individual was required to pay, in addition to a normal tax of 4 percent on the first \$4,000 net income and 8 [55] percent on the excess above \$4,000, a surtax ranging from 1 percent upon the first \$4,000 in excess of \$6,000 to 55 percent upon the net income in excess of \$1,000,000. Secs. 11 and 12. As pointed out in the above report, an individual receiving \$1,000.00 annual income from taxable bonds was subject under the then existing law to a tax of \$571,100. However, if he had formed a corporation and turned such bonds over to the corporation the only tax payable would be a tax of \$137,500 as long as no distribution of dividends was made by the corporation. Thus the formation of a corpora-

tion for the purpose of holding the securities and the retention by it of the income therefrom effected a tax saving to the individual of \$433,600. In the Revenue Act of 1934, Congress for the first time imposed a surtax of 30 percent upon the undistributed adjusted net income of every personal holding company as defined therein not in excess of \$100,000, plus 40 percent thereof in excess of \$100,000. Sec. 351. In section 109 of the Revenue Act of 1935 the rates provided for in section 351 of the 1934 Act were changed and ranged from 20 percent of the undistributed adjusted net income not in excess of \$2,000 to 60 percent of such income in excess of \$1,000,000. The rates were changed again in the Revenue Act of 1936. The surtaxes thus imposed were however ineffective to eliminate tax avoidance by means of a holding company. Report No. 1546, Committee on Ways and Means, 75th Cong., 1st sess., pp. 3-5. Section 351 of the Revenue Act of 1937 increased the rates to 65 percent of the undistributed adjusted net income of personal holding companies not in excess of \$2,000 plus 75 percent of such income in excess of \$2,000. The same rates were imposed by section 401 of the Revenue Act of 1938. This surtax was imposed in addition to the tax levied upon the taxable net income of corporations generally under section 13 of the Revenue Act of 1938 and corresponding sections of prior revenue acts referred to. See *Schinebro, Inc.*, 45 B. T. A. 580; affirmed on this point, 131 Fed. (2d) 504. The high surtax changed the tax status of a personal holding company from a tax benefit to a tax burden.

to the individual or individuals who caused its creation. The increased taxes were directed to the elimination of so flagrant a scheme of tax avoidance. The motive of tax avoidance which prompted creation of such a corporation would undoubtedly under the circumstances suggest a dissolution of the corporation for the purpose of minimizing tax liability, and we think petitioners' contention that, had they had reason to believe the tax assessed would be imposed the Wheeler Co. would not have been liquidated, is without substance.

The provisions of subsection (E) of section 112 (b) (7) were originally offered as an amendment to section 115 (c) as contained in the 1938 Revenue Bill (H. R. 9682) by Senator George for the [56] purpose of encouraging and facilitating prompt liquidation of personal holding companies, and other corporations falling outside of the technical classification of personal holding companies, which had not been used to evade taxes and had no substantial accumulation of earnings and profits but held real estate or unlisted corporate securities which were not readily marketable and had greatly appreciated in value, by postponing the tax on such unrealized appreciation in value imposed upon stockholders upon liquidation until the property is sold by the stockholders. He stated that the imposition of tax in such cases based upon the entire appreciation in value, even though unrealized from a business point of view, frequently compelled the sale of the property to establish the amount of taxable

gain or to raise the amount required to pay the tax, which discouraged liquidation, as a result of which the property remained frozen in the corporation since any gain realized from a sale of the assets by the corporation would not be entitled to the benefits of the capital gain provision when distributed to the stockholders. (Cong. Rec., vol. 83, pp. 5171-5172.)

The amendment offered by Senator George was finally incorporated in section 112, entitled "Recognition of Gain or Loss," and not in section 115, dealing with "Distributions by Corporations." This is highly significant. It indicates clearly that the terms and provisions thereof should be interpreted in the light of and in harmony with the rules and principles established by section 112, and sections 111 and 113 closely related therewith, and not by the principles established by cases relied upon by petitioners, particularly those which involved the question whether or not a corporate distribution was a taxable dividend within the meaning of section 115 of the Revenue Act of 1938 or the corresponding section of prior revenue acts. Section 112 (b) (7) makes no reference to section 115. In our opinion a reading of the statement made by Senator George and the fact of the inclusion of the amendment offered by him as an amendment to section 115 in section 112 instead of section 115 should have forewarned the petitioners that their interpretation of section 112 (b) (7) was mistaken and incorrect and not in accord with Congressional intent. By section 501 of the Second Revenue Act of 1940 such intent was made specific, as appears from Report No. 2894

from the Committee on Ways and Means, 76th Cong., 3d sess., pp. 41-42, pertaining to section 401 (later 501) amending section 115, wherein it is stated that:

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits tax purposes. [57]

* * * The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase or diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112 and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner v. Sansome*, 60 F. (2d) 931, and following decisions, the rule effectuates the provisions of section 112. * * *

The purpose of the amendment was not to provide a method of tax avoidance to stockholders of personal holding companies, but to provide for a post-ponement of tax to the extent of so much of the tax as would be imposed on the portion of the gain to the stockholders represented by an increase in value of the assets distributed, i. e., a gain which had not been realized by the corporation or the stockholders

from a business point of view. Increase or appreciation in value of corporate assets would be reflected in the gain realized by stockholders upon liquidation because the fair market value of such assets upon liquidation is a factor in determining gain or loss to the stockholders. Herein the gain, including the appreciation in value between cost to the transferors and value at the time of exchange, was realized upon the sale by the corporation of the securities transferred to it for its stock.

The gain realized by the stockholders of the Wheeler Co. upon its liquidation in 1938 was taxable under the Revenue Act of 1938 either under section 112 (b) (7) to the extent therein provided or under section 115 (c) of that act in the event the election granted by section 112 (b) (7) had not been exercised. Hence section 501 (a) of the Second Revenue Act of 1940 did not impose a tax upon a transaction the gains of which were not taxable in 1938, as was the situation in *Nichols v. Coolidge*, *supra*; *Blodgett v. Holden*, *supra*; and *Untermeyer v. Anderson*, *supra*. Such cases are not controlling herein. Justice Brandeis, in his dissenting opinion in *Untermeyer v. Anderson*, *supra*, stated: "Except for the peculiar tax involved in *Nichols v. Coolidge*, * * * no federal revenue measure has ever been held invalid on the score of retroactivity." In *Seattle v. Kelleher*, 195 U. S. 351, liability for taxes under retroactive legislation was stated to be "one of the notorious incidents of social life." Petitioners cited no other case holding a revenue statute invalid on the ground of retroactivity decided since

Untermeyer v. Anderson, *supra*. All the cases cited by them on briefs decided since the promulgation of the above three cases held the statutes involved valid, although attacked because retroactive in application.

Under section 112 (b) (7) each stockholder was taxable on (i) so much of his gain as was not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, [58] 1913, and (ii) so much of the remainder of his gain as was not in excess of the amount by which the value of that portion of the assets received by him which consisted of money, or stock or securities acquired by the corporation after April 9, 1938, exceeded his ratable share of such earnings and profits. The gain described in (i) was taxable as a dividend and the gain described in (ii) was taxable as a short term or long term gain, as the case might be. Tax on any gain above the gains enumerated was postponed until the disposition by the stockholder of the property received by him on liquidation. Taking the case of John H. Wheeler as illustrative, it appears that his gain on liquidation was \$159,177.85 as computed by the respondent, the correctness of which determination is not in dispute. The respondent determined that this gain was recognizable under section 112 (b) (7) to the extent of \$66,809.55, consisting of his ratable portion of securities acquired by the Wheeler Co. after April 9, 1938, of the value of \$346.94 and cash of \$55.92, both taxable as capital gain, and his ratable

share of corporate earnings and profits of \$66,406.69 taxable as a dividend. As hereinafter stated, the petitioners claim, and correctly so, that the amount of corporate earnings and profits as determined by the respondent should be reduced by the amount of \$5,953.06, additional surtax on undistributed profits for 1936. Since John H. Wheeler owned one-half of the stock, his ratable share of the corporate earnings will be reduced by one-half of such amount and the amount of gain recognizable to him will be reduced accordingly. The remainder of the gain is not recognizable under section 112 (b) (7) for tax purposes until and unless realized by the stockholder on the disposition of the securities received by him on liquidation. Furthermore, the basis of such securities for computing gain or loss on future sales or other disposition thereof under the provisions of section 113 (a) (18) is decreased by the amount of cash received and increased by the amount of gain recognizable to him, which results in a substantially increased basis to the stockholder. Whether or not he will ever pay a tax on the gain not recognizable under section 121 (b) (7) can not be presently determined. If the stockholders had not elected to liquidate under section 112 (b) (7), the gain to the extent of 50 percent would have been taxable to John H. Wheeler under section 115 (c), or the amount of \$79,588.93. It cannot be said that the application of the provisions of section 501 (a) to section 112 (b) (7) results in a harsh tax, since the gain recognizable thereunder is substantially less than the amount of gain which would have been tax-

able under section 115 (c). That the tax under section 112 (b) (7) is more than petitioners expected to pay by reason of their interpretation of the provisions of that section is not a ground for declaring section 501 invalid as arbitrary and con- [59] fiscatory. The petitioners elected to be taxed under section 112 (b) (7) and they can not complain if such election resulted in a greater tax than they expected to pay. It may be noted that the Wheeler Co. apparently was not the type of corporation section 112 (b) (7) was intended to aid. It did not hold "frozen" assets which had increased in value, which increase, although not realized, would have been taxable to the stockholders. The gain taxed was not an unrealized gain represented merely by an appreciation in value of assets held by the corporation; it represented a gain realized on sales by the Wheeler Co. of securities turned over to it by decedent and his wife, under sections 111, 112, and 113. As pointed out above, applying section 501 (a) to section 112 (b) (7), the gain recognizable was less than it would have been under section 115 (c), so that the petitioners were benefited to that extent at least.

We therefore conclude that section 501 of the Second Revenue Act of 1940 is not unconstitutional as applied to section 112 (b) (7) of the Revenue Act of 1938.

The petitioners do not question the amount of earnings and profits computed by the respondent under section 112 of the Revenue Act of 1938 as amended by section 501 of the Second Revenue Act of 1940, except that it is contended that, if section

501 is applicable, earnings and profits should be reduced by the amount of \$5,953.06. The Wheeler Co. in its 1936 return, in computing its surtax on undistributed profits, claimed a dividends paid credit of \$30,465.41, which the respondent disallowed, resulting in a deficiency in surtax on undistributed profits in the amount of \$5,935.06. The action of the respondent was approved by this Court in *Estate of John H. Wheeler*, 1 T. C. 401. The evidence therein showed that the 1936 income tax return of the company was made on the cash basis, which indicates that the books were kept on such basis. The respondent contends that the determination of earnings and profits available for distribution of dividends must follow the method of accounting employed by the corporation in computing its taxable income. In *M. H. Alworth Trust*, 46 B. T. A. 1045 (appeal pending, C. C. A., 8th Cir., Sept. 8, 1942), wherein a like question was involved and a similar argument was made by the respondent, it was held that, although the taxable income of the taxpayer therein was computed on the cash basis, in determining earnings and profits available for distribution as dividends, accrued but unpaid taxes must be taken into account. The decision in that case is controlling herein. The computation of the respondent, in so far as he failed to take into account the amount of \$5,953.06, accrued but unpaid surtax on undistributed profits for 1936, is therefore erroneous.

Decisions will be entered under Rule 50. [60]

Elliott H. Wheeler et al vs.

The Tax Court of the United States
Washington

Docket No. 107255

ESTATE OF JOHN H. WHEELER, DE-
CEASED, ELLIOTT H. WHEELER AND
ROLLO C. WHEELER, EXECUTORS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's opinion promulgated February 24, 1943, the respondent herein having filed a recomputation of tax on April 1, 1943, and petitioner having filed an acquiescence therein on April 26, 1943, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax of \$28,123.46 for the calendar year 1938.

(Seal) (Signed) WILLIAM W. ARNOLD
Judge.

Entered Apr. 29, 1943. [61]

Commissioner of Internal Revenue

In The Tax Court of the United States

Docket No. 107255

Docket No. 107258

Docket No. 107260

Docket No. 107263

Docket No. 107265

**ESTATE OF JOHN H. WHEELER, DE-
CEASED**

CORNELIA W. GOOD

ELLIOTT H. WHEELER

FRANCES V. WHEELER

YSABEL F. BERLINER,

Petitioners,

v.

**COMMISSIONER OF INTERNAL REVENUE,
Respondent.**

**PETITION FOR REVIEW BY THE UNITED
STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT OF A DEC-
ISION OF THE TAX COURT OF THE
UNITED STATES**

To the Honorable, the Judges of the United States
Circuit Court of Appeals for the Ninth Circuit:

Elliott H. Wheeler and Rollo C. Wheeler, as
executors of the last will and testament of John H.
Wheeler, deceased, respectfully petition this court
to review the decision of The Tax Court of the
United States entered on April 29, 1943, pursuant
to an opinion promulgated by that court on Feb-
ruary 24, 1943, and they allege:

I. VENUE

Petitioners Elliott H. Wheeler and Rollo C. Wheeler were appointed executors of the last will and testament of [62] John H. Wheeler, deceased, by the Superior Court of the State of California, in and for the County of Napa, on July 5, 1939. Ever since said date they have been and now are the duly appointed, qualified and acting executors of the last will and testament of said decedent, who died in the County of Napa on June 14, 1939.

The decedent filed his income tax return for the year 1938 with the Collector of Internal Revenue, First District of California, in the City and County of San Francisco, State of California. An assessment against the estate of said decedent for income taxes claimed to be due for the year 1938 was the subject matter of said proceedings in The Tax Court of the United States. The circuit Court of Appeals for the Ninth Circuit is the court in which petitioners seek a review of said decision of April 29, 1943.

II. NATURE OF THE CONTROVERSY

Decedent was a stockholder of the John H. Wheeler Company, a California corporation. The John H. Wheeler Company was a personal holding corporation. When incorporated it had issued its capital stock in exchange for certain securities transferred to it by its incorporators. In 1938 the decedent and all of the other stockholders of the

John H. Wheeler Company elected to liquidate said company under the provisions of Section 112 (b) (7) of the Revenue Act of 1938. Under this [63] section that portion of the gain realized by each stockholder on liquidation which was not in excess of his ratable share of the earnings and profits of the corporation was recognizable and taxable as a dividend. In computing gain or loss for income tax purposes on the sale of the securities transferred to it in exchange for its capital stock, the corporation used its transferors' basis, but in computing the earnings and profits as shown by its books of account, and for the purpose of Section 112 (b) (7), it used as a basis the fair market value of the securities at the time they were exchanged for its capital stock. The Commissioner of Internal Revenue used the transferors' basis in computing earnings and profits under Section 112 (b) (7) of the Revenue Act of 1938, and in doing so relied on the provisions of Section 501 of the Second Revenue Act of 1940. The application by the Commissioner of the provisions of Section 501 of the Second Revenue Act of 1940 to the dissolution which had been completed in 1938, resulted in a deficiency of \$28,123.46 in income taxes over the amount of taxes paid by the decedent in 1938. Petitioners protested the application by the Commissioner of the provisions of Section 501 of the Second Revenue Act of 1940 to a dissolution which had been completed in the year 1938. The Tax Court of the United States approved the action of the Commissioner and decided that there was a deficiency in income taxes due from the estate of

said decedent of \$28,123.46 for the calendar year 1938. [64]

III.

ASSIGNMENTS OF ERROR

Petitioners assign as error the following acts and omissions of The Tax Court of the United States:

(1) The finding that any additional taxes are due from the estate of said decedent on income received by, or chargeable to, said decedent in the year 1938;

(2) The failure to apply to the dissolution of the John H. Wheeler Company in the year 1938 the provisions of Section 112 (b) (7) of the Revenue Act of 1938 and the definition of the words "earnings and profits," which are found in this section, as such definition is uniformly established by the decisions of the courts of the United States;

(3) In applying retroactively the provisions of Section 501 of the Second Revenue Act of 1940 to the liquidation of the John H. Wheeler Company when this liquidation had been effected pursuant to the provisions of Section 112 (b) (7) of the Revenue Act of 1938;

(4) The failure to find that Section 501 of the Second Revenue Act of 1940 would violate the due process clause of the Fifth Amendment of the Constitution of the United States if it be applied to the dissolution in 1938 of a corporation liquidated and dissolved pursuant to the provisions of Section 112 (b) (7) of the Revenue Act of 1938;

(5) In holding that the application of the provisions of [65] Section 501 of the Second Revenue Act

of 1940 to Section 112 (b) (7) of the Revenue Act of 1938 does not result in a tax which might not have been expected or anticipated;

(6) In assigning tax avoidance as the motive for the formation or the dissolution of the John H. Wheeler Company;

(7) In finding that the John H. Wheeler Company would have been liquidated by its stockholders even though Section 112 (b) (7) of the Revenue Act of 1938 had not been made the law of the United States;

(8) In finding that it was advisable for the John H. Wheeler Company to liquidate.

Wherefore, petitioners pray that the decision of The Tax Court of the United States made and entered in the above entitled matter on April 29, 1943, pursuant to an opinion of said court which had been promulgated on February 24, 1943, be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit; that a transcript of the record be prepared in accordance with law and the rules of said Circuit Court for filing therein, and that all appropriate action be taken to the end that the errors complained of herein may be rectified and corrected by said Court.

VINCENT H. O'DONNELL

Attorney for petitioners, Elliott H. Wheeler and Rollo C. Wheeler, executors of the last will and testament of John H. Wheeler, Deceased

1820 Mills Tower, San Francisco, California [66]

State of California,
City and County of San Francisco.—ss.

Vincent H. O'Donnell, being first duly sworn, deposes and says:

I am the attorney of record for the petitioners named in the foregoing petition for review. I have read said petition for review and know the contents thereof. The facts set forth therein are true of my own knowledge.

VINCENT H. O'DONNELL

Subscribed and sworn to before me, this 23rd day of July, 1943

(Seal)

CATHERINE E. KEITH

Notary Public in and for the City and County of San Francisco, State of California.

[Endorsed]: T.C.U.S. Filed July 26, 1943. [67]

[Title of Tax Court and Cause.]

Dockets Numbered 107255, 107258, 107260,
107263, and 107265

**NOTICE OF FILING PETITION
FOR REVIEW**

To the Respondent, the Commissioner of Internal Revenue, and to John P. Wenchel, Chief Counsel, Attorney for Respondent, Bureau of Internal Revenue Building, Washington, D. C.:

You, and Each of You, Are Hereby Notified that on this 24th day of July, 1943, a petition by Elliott H. Wheeler and Rollo C. Wheeler, as executors of the last will and testament of John H. Wheeler,

deceased, for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of The Tax Court of the United States entered in the above entitled cause on April 29, 1943, pursuant to a decision which had been promulgated on February 24, 1943, was mailed by United States Mail to the Clerk of The Tax Court of the United States by said Elliott H. Wheeler and Rollo C. Wheeler, as executors of the last will and testament of John H. Wheeler, deceased. A copy of the petition as filed is attached hereto and served upon you.

Dated: July 24th, 1943.

(S) VINCENT H. O'DONNELL.

Attorney for Elliott H. Wheeler and Rollo C. Wheeler, executors of the last will and testament of John H. Wheeler, deceased. [68]

Service of the foregoing notice of filing and of a copy of the petition for review is hereby acknowledged this 27th day of July, 1943.

(S) J. P. WENCHEL,

Chief Counsel, Bureau of Internal Revenue; Attorney for Respondent.

[Endorsed]: T.C.U.S. Filed July 28, 1943.

[69]

In the Tax Court of the United States

Docket No. 107255

**ESTATE OF JOHN H. WHEELER,
DECEASED,**

Petitioner,

v.

**COMMISSIONER OF INTERNAL REVENUE,
Respondent.**

**STATEMENT OF POINTS ON WHICH
PETITIONER INTENDS TO RELY**

On the review of the decision of The Tax Court of the United States in the above entitled proceedings by the United States Circuit Court of Appeals for the Ninth Circuit, the petitioner above named intends to rely upon the following:

1. The oral and written stipulation of facts entered into by the petitioner and the respondent at the trial on May 24, 1941, before The Tax Court of the United States; and

2. The assignments of error set forth by the petitioner above named in its petition for review filed in the above entitled proceedings on July 26, 1943.

Dated: August 2, 1943.

VINCENT H. O'DONNELL

Attorney for the petitioner
above named.

Service of the foregoing statement of points on which petitioner intends to rely is hereby admitted this 17th day of August, 1943.

J. P. WENCHEL

C A R

Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent on Review.

[Endorsed]: T.C.U.S. Filed Aug. 18, 1943. [70]

[Title of Tax Court and Cause.]

STIPULATION AS TO RECORD

It is hereby stipulated and agreed:—

(1) The record, proceedings and evidence to be included in the record on appeal in the above entitled matter shall be the parts of the record, proceedings and evidence set forth in the Designation of Contents of Record on Appeal, which is attached to and is made a part of this stipulation;

(2) A single record on appeal shall be prepared containing all of the matters designated in said appellant's Designation of Contents of Record on Appeal, without duplication, save as hereinafter provided, for use in connection with the petitions for review and the proceedings on appeal which bear the following docket numbers:

Name of Petitioner:	Docket Number
Estate of John H. Wheeler, deceased.....	107255
Cornelia W. Good	107258

Elliott H. Wheeler	107260
Frances V. Wheeler	107263
Ysabel F. Berliner	107265

[71]

(3) Only the petition for redetermination filed on May 12, 1941, in docket No. 107255 and the answer thereto need be made part of said record on appeal. It is stipulated in this connection that all of the petitions for redetermination and all of said answers to said petitions filed by the petitioners under the five docket numbers above cited are substantially identical and differ only as to the names of the taxpayers and the amounts of taxes involved;

(4) Only the petition for review filed under docket No. 107255 and the notice of filing the petition for review in proceeding No. 107255 need be made a part of the record. It is further stipulated in this connection that all of the petitions and all of the notices filed under the five docket numbers above noted are substantially identical and differ only as to the names of the taxpayers and the amounts of taxes involved;

(5) Only the statement of the points on which the petitioners intend to rely under docket No. 107255 need be made part of the record, and it is further stipulated in this connection that the statements filed under the other docket numbers are substantially identical and differ only as to the names of the taxpayers and the amounts of taxes involved;

(6) Only this stipulation as to record filed under docket No. 107255 need be made part of the said

record, and it is further stipulated in this connection that the stipulations filed under the other docket numbers are substantially identical and differ only as to the names of the taxpayers involved;

[72]

(7) The Circuit Court of the United States in and for the Ninth Circuit may consolidate said proceedings under the above noted docket numbers for purposes of record, briefing, hearing and decision, and for all other purposes.

Dated: August 2, 1943.

VINCENT H. O'DONNELL

Attorney for petitioner above
named.

(Signed) J. P. WENCHEL

[ILLEGIBLE]

Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent on Review. [73]

DESIGNATION OF CONTENTS OF RECORD ON APPEAL

In compliance with the provisions of paragraph (a) of Rule 75 of the Rules of Civil Procedure for the District Courts of the United States as made applicable to review of a decision of the Tax Court of the United States by Rule 30 of the Rules of the United States Circuit Court of Appeals for the Ninth Circuit, the above-named petitioners and respondent hereby designate the portions of the record, proceedings, and evidence to form the rec-

ord on review of the above-entitled proceedings, to wit:

1. All docket entries in the proceedings before the Tax Court of the United States.

2. The petition for redetermination filed May 12, 1941, in docket No. 107255.

3. The answer to said petition filed July 8, 1941, in docket No. 107255.

4. The stipulation of facts dated March 27, 1942, filed in these proceedings on May 24, 1942.

5. The oral stipulation on the hearing on May 24, 1942, as reported by the official reporter of the above-entitled Court.

6. Petitioner's exhibits No. 1 and No. 2 received in evidence in the above-entitled matter.

7. Findings of fact and memorandum of opinion of the [74] Tax Court promulgated on February 24, 1943, in the above-entitled matter.

8. Decision of the Tax Court entered April 29, 1943, in the above-entitled matter.

9. Petition for review by the United State Circuit Court of Appeal for the Ninth Circuit of the decision of the Tax Court of the United States, filed in docket No. 107255, in the above-entitled matter.

10. Notice of filing petition for review and admission of service thereof, filed in docket No. 107255.

11. Statements of points on which petitioners intend to rely, bearing the date hereof, filed in docket No. 107255.

12. Order of the United States Circuit Court of

Appeals, Ninth Circuit, for consolidation of the record.

13. This designation of contents of record on appeal, and the stipulation which precedes it, as filed in docket No. 107255.

Dated: August 2, 1943.

VINCENT H. O'DONNELL

Attorney for Petitioners

(Signed) J. P. WENCHEL

[ILLEGIBLE]

Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent on Review.

[Endorsed]: T.C.U.S. Filed Aug. 18, 1943. [75]

The Tax Court of the United States
Washington

Docket No. 107255

ESTATE OF JOHN H. WHEELER, DECEASED, CORNELIA W. GOOD, ELLIOTT H. WHEELER, FRANCIS V. WHEELER, YSABEL F. BERLINER,

Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing

pages, 1 to 75, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praeceptum in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 23d day of August, 1943.

[Seal]

B. D. GAMBLE

Clerk,

The Tax Court of the United
States.

APPEARANCES:

For Taxpayer:

**VINCENT H. O'DONNELL, Esq.,
JOHN D. BRETHAUER, C.P.A.,**

For Comm'r:

HARRY R. HORROW, Esq.,

Docket No. 107258

MRS. CORNELIA W. GOOD,

Petitioner,

vs.

**COMMISSIONER OF INTERNAL REVENUE,
Respondent.**

DOCKET ENTRIES

1941

May 12—Petition received and filed. Taxpayer notified. Fee paid.

May 12—Copy of petition served on General Counsel.

May 12—Request for hearing in San Francisco, Calif., filed by taxpayer. 5-12-41 copy served.

May 26—Praecipe for appearance of John D. Brethauer, as counsel for petitioner, filed.

Jul. 8—Answer filed by General Counsel.

Jul. 15—Copy of answer served on taxpayer. San Francisco, California.

1942

Feb. 25—Hearing set March 23, 1942—San Francisco, California.

Mar. 28—Hearing had before Mr. Arnold on merits—Submitted. Counsel moves to consolidate Dockets 107255-58-60-63 and 65, granted. Stipulation of facts filed. Briefs due May 15, 1942. Replies June 15, 1942.

Apr. 20—Transcript of hearing 3-28-42 filed.

May 15—Brief filed by taxpayer. (5-16-42—3 copies received).

May 15—Brief filed by General Counsel. Copy served 5-16-42.

May 16—Copy of brief served on General Counsel.

Jun. 15—Reply brief filed by taxpayer.

Jun. 15—Reply brief filed by General Counsel. Copy served 6-16-42.

Jun. 15—Copy of reply brief served on General Counsel.

1943

Feb. 24—Opinion rendered—Arnold, Judge. Div. 12. Decision will be entered under Rule 50. 3-3-43 Copy served.

Apr. 1—Computation of deficiency filed by General Counsel.

Apr. 3—Hearing set May 5, 1943 on settlement.

Apr. 26—Consent to settlement filed by taxpayer.

Apr. 29—Decision entered. Arnold, Judge. Div. 12.

Jul. 26—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

Jul. 26—Affidavit of service by mail filed by taxpayer.

1943

Jul. 28—Proof of service of filing petition for review filed by taxpayer.

Aug. 18—Statement of points with proof of service thereon filed.

Aug. 18—Stipulation re record with agreed praecipe attached, filed. [1*]

The Tax Court of the United States
Washington

Docket No. 107258

CORNELIA W. GOOD,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's opinion promulgated February 24, 1943, the respondent herein having filed a recomputation of tax on April 1, 1943, and petitioner having filed an acquiescence therein on April 26, 1943, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax of \$1,561.51 for the calendar year 1938.

(Signed) WILLIAM W. ARNOLD

[Seal]

Judge.

Entered April 29, 1943. [2]

[Title of Tax Court and Cause.]

**CERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD**

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 2, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office deleted as called for by Praecipe and Stipulation of the Parties filed in Docket Number 107255.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 23d day of August, 1943.

[Seal]

B. D. GAMBLE

Clerk,

The Tax Court of the United
States.

APPEARANCES:

For Taxpayer:

**VINCENT H. O'DONNELL, Esq.,
JOHN D. BRETHAUER, C.P.A.,**

For Comm'r:

HARRY R. HORROW, Esq.,

Docket No. 107260

ELLIOTT H. WHEELER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1941

May 12—Petition received and filed. Taxpayer notified. Fee paid.

May 12—Copy of petition served on General Counsel.

May 12—Request for hearing in San Francisco, Calif., filed by taxpayer. 5-12-41 copy served.

May 26—Praecipe for appearance of John D. Brethauer, as counsel for petitioner, filed.

Jul. 8—Answer filed by General Counsel.

Jul. 15—Copy of answer served on taxpayer. San Francisco, California.

1942

Feb. 25—Hearing set March 23, 1943—San Francisco, California.

Mar. 28—Hearing had before Mr. Arnold on merits—Submitted. Counsel moves to consolidate Dockets 107255-58-60-63 and 65, granted. Stipulation of facts filed. Briefs due May 15, 1942. Replies June 15, 1942.

Apr. 20—Transcript of hearing 3-28-42 filed.

May 15—Brief filed by taxpayer. (5-16-42—3 copies received).

May 15—Brief filed by General Counsel. Copy served 5-16-42.

May 16—Copy of brief served on General Counsel.

Jun. 15—Reply brief filed by taxpayer.

Jun. 15—Reply brief filed by General Counsel. Copy served 6-16-42.

Jun. 15—Copy of reply brief served on General Counsel.

1943

Feb. 24—Opinion rendered—Arnold, Judge. Div. 12. Decision will be entered under Rule 50. 3-3-43 Copy served.

Apr. 1—Computation of deficiency filed by General Counsel.

Apr. 3—Hearing set May 5, 1943 on settlement.

Apr. 26—Consent to settlement filed by taxpayer.

Apr. 29—Decision entered. Arnold, Judge. Div. 12.

Jul. 26—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

Jul. 26—Affidavit of service by mail filed by taxpayer.

1943.

Jul. 28—Proof of service of filing petition for review filed by taxpayer.

Aug. 18—Statement of points with proof of service thereon filed.

Aug. 18—Stipulation re record with agreed praecipe attached, filed. [1*]

The Tax Court of the United States
Washington

Docket No. 107260

ELLIOTT H. WHEELER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's opinion promulgated February 24, 1943, the respondent herein having filed a recomputation of tax on April 1, 1943, and petitioner having filed an acquiescence therein on April 26, 1943, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax of \$2,009.20 for the calendar year 1938.

(Signed) WILLIAM W. ARNOLD

[Seal] Judge.

Entered April 29, 1943. [2]

[Title of Tax Court and Cause.]

**CERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD**

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 2, inclusive contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office deleted as called for by Praecipe and Stipulation of the parties filed in Docket Number 107255.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 23d day of August, 1943.

[Seal]

B. D. GAMBLE

Clerk,

The Tax Court of the United
States.

APPEARANCES:

For Taxpayer:

VINCENT H. O'DONNELL, Esq.,
JOHN D. BRETHAUER, C.P.A.,

For Comm'r:

HARRY R. HORROW, Esq.,

Docket No. 107263

MRS. FRANCES V. WHEELER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1941

May 12—Petition received and filed. Taxpayer notified. Fee paid.

May 12—Copy of petition served on General Counsel.

May 12—Request for hearing in San Francisco, Calif., filed by taxpayer. 5-12-41 copy served.

May 26—Praecipe for appearance of John D. Brethauer, as counsel for petitioner, filed.

Jul. 8—Answer filed by General Counsel.

Jul. 15—Copy of answer served on taxpayer. San Francisco, California.

1942

Feb. 25—Hearing set March 23, 1942—San Francisco, California.

Mar. 28—Hearing had before Mr. Arnold on merits—Submitted. Counsel moves to consolidate Dockets 107255-58-60-63 and 65, granted. Stipulation of facts filed. Briefs due May 15, 1942. Replies June 15, 1942.

Apr. 20—Transcript of hearing 3-28-42 filed.

May 15—Brief filed by taxpayer. (5-16-42—3 copies received).

May 15—Brief filed by General Counsel. Copy served 5-16-42.

May 16—Copy of brief served on General Counsel.

Jun. 15—Reply brief filed by taxpayer.

Jun. 15—Reply brief filed by General Counsel. Copy served 6-16-42.

Jun. 15—Copy of reply brief served on General Counsel.

1943

Feb. 24—Opinion rendered—Arnold, Judge. Div. 12. Decision will be entered under Rule 50. 3-3-43 Copy served.

Apr. 1—Computation of deficiency filed by General Counsel.

Apr. 3—Hearing set May 5, 1943 on settlement.

Apr. 26—Consent to settlement filed by taxpayer.

Apr. 29—Decision entered. Arnold, Judge. Div. 12.

Jul. 26—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

Jul. 26—Affidavit of service by mail filed by taxpayer.

1943

Jul. 28—Proof of service of filing petition for review filed by taxpayer.

Aug. 18—Statement of points with proof of service thereon filed.

Aug. 18—Stipulation re record with agreed praecipe attached, filed. [1*]

The Tax Court of the United States
Washington

Docket No. 107263

FRANCIS V. WHEELER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Court's opinion promulgated February 24, 1943, the respondent herein having filed a recomputation of tax on April 1, 1943, and petitioner having filed an acquiescence therein on April 26, 1943, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax of \$2,546.02 for the calendar year 1938.

(Signed) WILLIAM W. ARNOLD

[Seal] Judge.

Entered April 29, 1943. [2]

[Title of Tax Court and Cause.]

**CERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD**

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 2, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office deposed as called for by Praecipe and Stipulation of the Parties filed in Docket Number 107255.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 23d day of August, 1943.

[Seal]

B. D. GAMBLE

Clerk,

The Tax Court of the United
States.

APPEARANCES:

For Taxpayer:

VINCENT H. O'DONNELL, Esq.,

JOHN D. BRETHAUER, C.P.A.,

For Comm'r:

HARRY R. HORROW, Esq.,

Docket No. 107265

MRS. YSABEL F. BERLINER,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1941

May 12—Petition received and filed. Taxpayer notified. Fee paid.

May 12—Copy of petition served on General Counsel.

May 12—Request for hearing in San Francisco, Calif., filed by taxpayer. 5-12-41 copy served.

May 26—Praecipe for appearance of John D. Brethauer, as counsel for petitioner, filed.

Jul. 8—Answer filed by General Counsel.

Jul. 15—Copy of answer served on taxpayer. San Francisco, California.

1942

Feb. 25—Hearing set March 23, 1942—San Francisco, California.

Mar. 28—Hearing had before Mr Arnold on merits
—Submitted. Counsel moves to consolidate
Dockets 107255-58-60-63 and 65, granted.
Stipulation of facts filed. Briefs due May
15, 1942. Replies June 15, 1942.

Apr. 20—Transcript of hearing 3-28-42 filed.

May 15—Brief filed by taxpayer. (5-16-42—3 copies received).

May 15—Brief filed by General Counsel. Copy served 5-16-42.

May 16—Copy of brief served on General Counsel.

Jun. 15—Reply brief filed by taxpayer.

Jun. 15—Reply brief filed by General Counsel. Copy served 6-16-42.

Jun. 15—Copy of reply brief served on General Counsel.

1943

Feb. 24—Opinion rendered—Arnold, Judge. Div. 12.
Decision will be entered under Rule 50.
3-3-43 Copy served.

Apr. 1—Computation of deficiency filed by General Counsel.

Apr. 3—Hearing set May 5, 1943 on settlement.

Apr. 26—Consent to settlement filed by taxpayer.

Apr. 29—Decision entered. Arnold, Judge. Div. 12.

Jul. 26—Petition for review by U. S. Circuit Court
of Appeals, 9th Circuit, with assignments
of error filed by taxpayer.

Jul. 26—Affidavit of service by mail filed by taxpayer.

1943

Jul. 28—Proof of service of filing petition for review filed by taxpayer.

Aug. 18—Statement of points with proof of service thereon filed.

Aug. 18—Stipulation re record with agreed praecipe attached, filed. [1*]

The Tax Court of the United States
Washington

Docket No. 107265

YSABEL F. BERLINER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the Court's opinion promulgated February 24, 1943, the respondent herein having filed a recomputation of tax on April 1, 1943, and petitioner having filed an acquiescence therein on April 26, 1943, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax of \$1,384.96 for the calendar year 1938.

(Signed) WILLIAM W. ARNOLD

[Seal] Judge.

Entered April 29, 1943. [2]

[Title of Tax Court and Cause.]

**CERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD**

I, B. D. Gamble, clerk of the Tax Court of the United States do hereby certify that the foregoing pages, 1 to 2, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office deleted as called for by Praecept and Stipulation of the parties filed in Docket Number 107255.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 23d day of August, 1943.

[Seal]

B. D. GAMBLE

Clerk,

The Tax Court of the United
States.

[Endorsed]: No. 10538. United States Circuit Court of Appeals for the Ninth Circuit. Elliott H. Wheeler and Rollo C. Wheeler, Executors of the Estate of John H. Wheeler, deceased, Cornelia W. Good, Elliott H. Wheeler, Francis V. Wheeler, and Ysabel F. Berliner, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review Decisions of Tax Court of the United States.

Filed September 1, 1943.

PAUL P. O'BRIEN

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals
For the Ninth Circuit

T. C. Docket No. 107255

ESTATE OF JOHN H. WHEELER, Deceased,
Elliott H. Wheeler and Rollo C. Wheeler, Exec-
utors,

Petitioner on Review

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

T. C. Docket No. 107258

CORNELIA W. GOOD,

Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

T. C. Docket No. 107260

ELLIOTT H. WHEELER,

Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

T. C. Docket No. 107263

FRANCES V. WHEELER,

Petitioner on Review,

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

T. C. Docket No. 107265

YSABEL F. BERLINER,

Petitioner on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

**ORDER FOR CONSOLIDATION
OF THE RECORD**

Upon consideration of the motion filed herein by counsel for the petitioners on review in the above entitled proceedings, moving the Court to consolidate said proceedings for purposes of the record, the briefing, the hearing, the decision and for all other purposes connected with the final disposition of such proceedings on review, it is this 24th day of August, 1943,

Ordered that said motion be and it is hereby granted.

It Is Further Ordered that a certified copy of the motion and this order be transmitted by the Clerk

of this Court to the Clerk of The Tax Board of the United States.

FRANCIS A. GARRECHT
United States Circuit Judge.

[Title of Circuit Court of Appeals and Causes.]

MOTION TO CONSOLIDATE PROCEEDINGS

The above named petitioners on review move the Court to consolidate the above entitled proceedings for purposes of the record, the briefing, the hearing, the decision, and for all other purposes connected with the final disposition of said proceedings on review.

Pursuant to a stipulation of the parties, the above entitled proceedings were consolidated for the purpose of trial, record, briefing and decision in The Tax Court of the United States. After a trial of the proceedings, decisions were rendered in each proceeding based upon one opinion which was promulgated by said Tax Court on February 24, 1943. Each petitioner on review relies upon the same record and upon identical grounds for reversal.

Petitioners rely upon Rule 75(k) of the Rules of Civil Procedure for the District Courts of the United States as their authority in support of this motion.

Dated: August 2, 1943.

VINCENT H. O'DONNELL

Attorney for the above named
petitioners on review,
1820 Mills Tower Building,
San Francisco, California.

NOTICE OF MOTION

To: J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue,
Attorney for Respondent on Review,
Bureau of Internal Revenue Building,
Washington, D. C.

Please take notice, the undersigned will bring the foregoing motion on for hearing before the above entitled Court, Room 330 United States Courthouse and Post Office Building, San Francisco, California, on the 23rd day of August, 1943, at 10 o'clock in the forenoon of that day or as soon thereafter as counsel may be heard.

VINCENT H. O'DONNELL

Attorney for the above named
petitioners on review,
1820 Mills Tower Building,
San Francisco, California.

Receipt of the foregoing motion for hearing and notice of motion is hereby admitted this 17th day of August, 1943.

J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue, Attorney
for Respondent on Review.

[Endorsed]: Filed Aug. 24, 1943. Paul P. O'Brien, Clerk.

United States Circuit Court of Appeals
For the Ninth Circuit

No. 10538

ESTATE OF JOHN H. WHEELER, DECEASED,
Elliott H. Wheeler, and Rollo C. Wheeler,
Executors, CORNELIA W. GOOD, ELLIOTT
H. WHEELER, FRANCES V. WHEELER,
and YSABEL F. BERLINER,
Petitioners on Review,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent on Review.

STATEMENT OF POINTS ON WHICH PETITIONERS ON REVIEW INTEND TO RELY
ON APPEAL

Pursuant to the provisions of Section 6 of Rule
19 of the Rules of the United States Circuit Court

of Appeals for the Ninth Circuit, the petitioners on review make the following statement of the points on which they intend to rely:

Points

(1) The failure of the Commissioner of Internal Revenue and The Tax Court to apply to the dissolution of the John H. Wheeler Company in the year 1938 the definition of the words "earnings and profits," which are found in Section 112(b)(7) of the Revenue Act of 1938, the definition of which is well established by the decisions of the courts of the United States;

(2) The application retroactively by The Tax Court and the Commissioner of Internal Revenue of the provisions of Section 501 of the Second Revenue Act of 1940 to the liquidation of the John H. Wheeler Company, when this liquidation had been effected pursuant to the provisions of Section 112(b)(7) of the Revenue Act of 1938;

(3) The failure of The Tax Court and the Commissioner to find that Section 501 of the Second Revenue Act of 1940 would violate the due process of the Fifth Amendment of the Constitution of the United States if it be applied to the dissolution in 1938 of a corporation liquidated and dissolved pursuant to the provisions of Section 112(b)(7) of the Revenue Act of 1938;

(4) Holding that the application of the provisions of Section 501 of the Second Revenue Act of 1940 to Section 112(b)(7) of the Revenue Act of 1938 does not result in a tax which might not have been expected or anticipated;

(5) Assigning tax avoidance as the motive for the formation or the dissolution of the John H. Wheeler Company;

(6) Finding that the John H. Wheeler Company would have been liquidated by its stockholders even though Section 112(b)(7) of the Revenue Act of 1938 had not been made the law of the United States;

(7) Finding that it was advisable for the John H. Wheeler Company to liquidate;

(8) Finding that any additional taxes are due from the petitioners on income received by, or chargeable to, said petitioners in the year 1938.

Petitioners will also rely upon all of the assignments of error set forth in their petitions for review, and they will also rely upon all of the stipulations set forth in the "Stipulation as to Record" dated August 2, 1943, entered into by their counsel and by counsel for the Commissioner.

DESIGNATION OF RECORD

Pursuant to said Section 6 of Rule 19 the petitioners hereby designate as the parts of the record which they think necessary for a consideration of their appeals the portions of the records, proceedings and evidence particularly referred to in the "Designation of Contents of Record on Appeal" dated August 2, 1943, which is attached to a "Stipulation as to Record" bearing the same date; which was filed in The Tax Court of the United States on or about August 18, 1943, and petitioners request

the Court to print all of the portions of the records, proceedings and evidence therein referred to, together with the foregoing statement.

Dated: September 25, 1943.

VINCENT H. O'DONNELL

Attorney for Petitioners on
Review

[Endorsed] Filed Sept. 27, 1943. Paul P.
O'Brien, Clerk.

**IN THE UNITED STATES CIRCUIT COURT OF
APPEALS FOR THE NINTH CIRCUIT**

No. 10638

Excerpt from proceedings of Wednesday, February 16, 1944

**Before GARRECHT and STEPHENS, Circuit Judges, and McCormick,
District Judge**

ELLIOTT H. WHEELER, ET AL., PETITIONERS

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Order of submission

On ~~was~~ petition to review argued by Mr. Vincent O'Donnell, counsel for petitioners, and by Mr. Bernard J. Chertcoff, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from proceedings of Tuesday, May 16, 1944

Order directing filing of opinion and filing and recording of judgment

By direction of the Court, **ORDERED** that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this Court in accordance with the opinion rendered.

**Upon Petition to Review Decisions of the Tax Court of the
United States**

**Before GARRECHT and STEPHENS, Circuit Judges, and McCormick,
District Judge**

GARRECHT, Circuit Judge: The facts and questions of law involved are similar in five cases which have been consolidated.

The facts as stipulated by the parties were adopted by the Tax Court as its findings of fact.

John H. Wheeler Company was organized as a corporation under the laws of the State of California in the year 1925 by John H. Wheeler and Frances V. Wheeler, his wife. In the years following the organization of said company, and until the year 1929,

said John H. Wheeler and Frances V. Wheeler transferred to said company securities having a cost to them of \$304,683.49 in exchange for 4,918 shares of the common capital stock of said company. On the dates of exchange the securities transferred to John H. Wheeler Company for said 4,918 shares of its common capital stock had an aggregate fair market value of \$491,800.

In computing the gain or loss realized for federal income tax purposes on the sale of the particular securities which it had acquired following its organization, John H. Wheeler Company used the cost basis of said securities to its transferors, John H. Wheeler and Frances V. Wheeler.

In its books of account, said John H. Wheeler Company computed gain or loss on the sale of said particular securities by using the fair market value of the securities which were transferred to the corporation by John H. Wheeler and Frances V. Wheeler, as stated above.

On November 30, 1938, the books of account of the John H. Wheeler Company were closed and they showed a deficit of \$47,501.61. This deficit was caused principally by losses on the sale of securities acquired by the corporation following its organization computed on the basis of the fair market value of said securities at the time that they were transferred to the John H. Wheeler Company.

On December 2, 1938, John H. Wheeler, the decedent, Frances V. Wheeler, Elliott H. Wheeler, Cornelia W. Good and Ysabel F. Berliner and Rollo C. Wheeler (the latter not being involved in any of these proceedings) were the holders of all of the outstanding shares of stock of the John H. Wheeler Company.

On said December 2, 1938, after giving consideration to the application of Section 112 (b) (7) of the Revenue Act of 1938, the stockholders of the John H. Wheeler Company dissolved said corporation and all of its assets were distributed in liquidation during the month of December, 1938, proportionately to the stockholders of said company.

Pursuant to the provisions of Section 112 (b) (7) of the Revenue Act of 1938, John H. Wheeler, Frances V. Wheeler, Elliott H. Wheeler, Cornelia W. Good, and Ysabel F. Berliner executed written elections on Form 964 to have recognized and taxed in accordance with said section the gains on the shares of the capital stock of the said John H. Wheeler Company owned by them on December 2, 1938. Said individuals, in filing the federal income tax returns for the year 1938, reported as long-term capital gains their proportionate share of the securities acquired by the John H. Wheeler Company subsequent to April 9, 1938, and the cash which was distributed in liquidation. The distribution in liquidation

was completed during the month of December 1938, as required by the 1938 law.

No claim is made by the respondent that the proceedings taken by the John H. Wheeler Company and its stockholders to dissolve the said company and distribute its assets under Section 112 (b) (7) of the Revenue Act of 1938 were defective or incomplete. Pertinent provisions of said Act are printed in the margin.¹

More than two years after the liquidation of the corporation, and after tax returns thereon had been made, Congress enacted Section 501 (a) of the Second Revenue Act of 1940.²

¹ (7). Election as to recognition of gain in certain corporate liquidations.

(A) *General rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before, or after January 1, 1938; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)), gain upon shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subparagraphs (E) and (F).

(B) *Excluded corporation.*—The term "excluded corporation" means a corporation which at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 per centum or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(C) *Qualified electing shareholders.*—The term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D).

(D) *Making and filing of elections.*—The written elections referred to in subparagraph (C) must be made and filed in such manner as to be not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary. The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) *Noncorporate shareholders.*—In case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December 1938; and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

² (1) Effect on earnings and profits of gain or loss and of receipt of tax-free distributions. The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(a) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second

Subsequently, on February 12, 1942, the Commissioner of Internal Revenue asserted a deficiency in the tax returns of 1938.

The Commissioner in his claim for deficiency did not follow the provisions of Section 112 (b) (7) of the Revenue Act of 1938, but instead made use of the 1940 Act. The formula adopted by the Commissioner is shown by the following figures:

Fair market value of 4,918 shares of Wheeler Co. stock or fair market value of securities exchanged therefor, set up on corporate books as cost of securities	\$491,800.00
Cost of securities to decedent and wife transferred by them to Wheeler Co. for its stock	304,684.40
Excess of corporate book value over transferors' cost	187,115.51
Less deficit on corporate books as of December 31, 1938	47,501.61
Surplus as of December 31, 1938, based on transferors' cost	139,613.90
Less excess of book value over transferors' cost of securities unsold at liquidation of Wheeler Co.	8,800.52
Accumulated earnings and profits as of December 31, 1938, available for distribution to 4,918 shares of stock	132,813.38

The petitioners' computation of earnings and profits of Wheeler Co. differs from that of respondent in that petitioners assert that the earnings and profits of the John H. Wheeler Co. should be computed on the basis of cost to the company of the securities transferred to it in exchange for its 4,918 shares of stock, or on the basis of the fair market value of the securities on the date of transfer, and not the cost of the securities to the transferors as used by respondent in his computation of the deficiencies.

The Commissioner used the cost of the securities to Mr. and Mrs. Wheeler, the transferors at the time they acquired them, years before the formation of the corporation, as a basis for computing "earnings and profits," and he disregarded the increased market value they admittedly had at the time they were acquired by the corporation.

In other words, the respondent asserts that the gains which appear to inhere in the securities as computed by him, although unrealized by the shareholders, should nevertheless be classed as "earnings and profits" and taxed to petitioners as dividends. He claims as authority for his position Section 501 (a) of the Second Revenue Act of 1940. On the other hand, petitioners claim full compliance with the Act of 1938.

corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

The language of the decision of the Tax Court betrays an animus against petitioners because they were stockholders in this John H. Wheeler Company, which was a personal holding company and which, as it is suggested, was made use of for the purpose (although within the law) of tax evasion. The courts have held that it was permissible for taxpayers to avail themselves of such legal means; petitioners should not be condemned if such were the fact, which does not appear in this record. [See *Bullen v. Wisconsin*, 240 U. S. 625]

It is also suggested that the dissolution of the company, likewise, was motivated by purposes of tax avoidance. This conclusion is also outside of the record.

Other statements of the Tax Court not supported by the record are that the Wheeler Company would have been liquidated by its stockholders even if Section 112 (b) (7) of the Revenue Act of 1938 had not been enacted into law. The Tax Court's opinion also seems to question the good faith of the liquidation of the corporation under this 1938 Act, in view of the attitude of the Commissioner firmly adhering to his regulation and refusing to abide by or acquiesce in court decisions.

These assumptions unconsciously create an atmosphere of prejudice which might easily impair an impartial approach to the issues to be determined.

Admittedly, Section 112 (b) (7) was enacted for the purpose of encouraging and facilitating prompt liquidation of personal holding companies. To apply the construction here contended for by the Commissioner would not have furnished such or any encouragement for liquidation.

The construction placed upon the statute submitted by petitioners does not result in tax avoidance to stockholders but reflects a fair postponement of tax to the extent of so much of the tax as is here sought to be imposed on such an assumed portion of gain to the stockholders as may be represented as an estimate of increase of the value of the assets distributed, which gain has not been actually realized either by the corporation or the stockholders.

The increase or appreciation in value of corporate assets will be reflected in any gain realized by stockholders when actually converted upon liquidation.

Section 112 (b) (7) of the Revenue Act of 1938 provides that upon complete liquidation of a domestic corporation under subsection (7) there shall be recognized and taxed as dividends the ratable share of the earnings and profits of the corporation accumulated after February 28, 1913. The petitioners contend that the term "earnings and profits" of the corporation for the purposes of Section 112 (b) (7) should be computed in accordance with the

rules and decisions of the courts which hold that "taxable income" is not the equivalent of "earnings and profits" and that on disposition by a corporation of property acquired by the corporation in exchange for its stock in a transaction wherein gain is not recognizable for the purposes of computing "taxable income," the basis of such property to the corporation for the purpose of determining "earnings and profits" available for distribution of dividends is the cost of the property to the corporation at the time of the exchange. The Government's contention is that Congress resolved this question by enacting Section 501 (a) in 1940, and that earnings and profits should be computed by applying the provisions of this law. Section 501 provides specifically that it shall apply to the 1938 law. The question for our consideration is whether this amendment can be applied to the voluntary liquidation of a corporation completed in the year 1938 pursuant to the Revenue Act of 1938 which by its very terms was to be effective and operative only during and for the year 1938.

The petitioners contend that Section 501 of the Second Revenue Act of 1940, if properly construed, is not applicable to voluntary liquidation and dissolution of a corporation commenced and completed in 1938, but if it is construed to be applicable to a liquidation completed in 1938 such construction violates the rule of "permissible retroactivity" and that therefore Section 501 is unconstitutional as in violation of the due process clause of the Fifth Amendment to the Constitution of the United States.

The petitioners have cited a number of cases which support their contention that the basis for determining "earnings and profits" is the cost of the property to the corporation at the time of the exchange.¹ The Government contends this is in error but cites no cases. The Government in its brief points out that the Commissioner lost some of these cases involving the interpretation of the words "earnings and profits" but that he never receded from his position. Indeed, upon the argument before this court counsel for appellant boasted that the Commission had flouted the court and absolutely refused to abide by its holdings and continually relied for its authority solely on Article 115.2, Treasury Regulations.² The Government in elaborating further on this point says that finally the passage of the Second Revenue Act of 1940, particularly Section 501 (a), made effective the Government's position on this point. It is our belief, however, that the cases do not support the Commissioner's position, for if they had it would not have been necessary for the Commissioner to base this case on

Section 501 (a) of the Second Revenue Act of 1940 or to have awaited for the enactment of such legislation before applying such interpretation of earnings and profits to the liquidation of the Wheeler Company.

Furthermore, in the very recent case of *Estate of Fisher et al. v. Commissioner*, Docket No. 104601 * * * Tax Court * * * [C. C. H. Dec. 13, 734 (M)], where the Tax Court held that Section 501 (c) of the Revenue Act of 1940 did not apply as the case was pending on September 20, 1940, the Tax Court held that the case was not controlled by the Revenue Act of 1940 but was rather controlled by the decisions which hold that the basis of determining earnings and profits is the fair market value when acquired. There is no question but that this was the law when the dissolution of the Wheeler Corporation took place in 1938 and it is still the law where the Revenue Act of 1940 is not applicable.

The Government has based its case on the assumption that this Revenue Act of 1940 was clarifying legislation. It is true that Section 501 in its original draft recited that it was clarifying legislation, but this was eliminated before its passage. This position is untenable because the Commissioner's determination on earnings and profits had been challenged and, as the Government states, "the Commissioner lost some of these cases." While Section 501 specifically endorsed his position, still, if the law were clearly to the contrary as it was here, the section in question can not be said to be clarifying. It is obvious that it is a subsequent enactment in the law to obviate the force of the contrary court decisions and to change the law to give support to the Commissioner's position.

We come to the real point in issue—whether the legislation in question is permissibly retroactive when applied to the dissolution of the Wheeler Company in 1938.

First, it must be pointed out that Section 501 (a) of the Second Revenue Act of 1940 was passed by Congress in the second year after the corporation was dissolved and income tax paid and there were three Revenue Acts passed between the dissolution of the Wheeler Company and the enactment of Section 501 (a).

The rule is that revenue acts are not unconstitutional merely because they are retroactive [*Untermeyer v. Anderson*, 276 U. S. 449; *Billings v. United States*, 229 U. S. 261, 299; *Hecht v. Malley*, 235 U. S. 144] * * * whenever the imposition seemed consonant with justice and the conditions were not such as would ordinarily involve hardship. *Untermeyer v. Anderson*, *supra*.

In the year 1938, the Supreme Court decided the case of *Welch v. Henry*, 305 U. S. 134. In that case we find the best summary and statement of the law in respect to retroactive legislation:

"The equitable distribution of the costs of government through the medium of an income tax is a delicate and difficult task. In its performance experience has shown the importance of reasonable opportunity for the legislative body, in the revision of the tax laws, to distribute the increased costs of government among its taxpayers in the light of present need for revenue and with knowledge of the sources and amounts of the various classes of taxable income during the taxable period preceding revision. Without that opportunity accommodation of the legislative purpose to the need may be seriously obstructed if not defeated. We cannot say that due process which the Constitution exacts denies that opportunity to legislatures; that it withholds from them, more than in the case of a prospective tax, authority to distribute the increased tax burden in the light of experience and in conformity with accepted notions of the requirements of equal protection; or that in view of well established legislative practice, both state and national, taxpayers can justly assert surprise and complain of arbitrary action in the retroactive apportionment of tax burdens to income at the first opportunity after knowledge of the nature and amount of the income is available. And we think that the 'recent transactions' to which this Court has declared a tax law may be retroactively applied, *Cooper v. United States*, 280 U. S. 409, 411, must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment [Also, *U. S. v. Hudson*, 290 U. S. 498, 500].

"The Joint Resolution of Congress of July 4, 1864, No. 77, 13 Stat. 417, imposed an additional tax on incomes earned during the calendar year 1863, this tax being imposed after the taxes for the year had been paid. In *Stockdale v. Insurance Companies*, *supra*, 331, Mr. Justice Miller said of it: 'The right of Congress to have imposed this tax by a new statute, although the measure of it was governed by the income of the past year, cannot be doubted. . . . no one doubted the validity of the tax or attempted to resist it.' The Act of February 24, 1919, c. 18, Tit. 2, 40 Stat. 1057, 1058-1059, which taxed incomes for the calendar year 1918, was applied without question as to its constitutionality in *United States v. Robbins*, 269 U. S. 315, and in other cases.

"In the present case, the returns of income received in 1933 were filed and became available in March 1934. Wisconsin, Stats. 1933, Sec. 71.09 (4). The next succeeding session of the legislature at which tax legislation could be considered was in 1935, when the challenged statute was passed. By Sec. 11, Art. IV; Sec. 4, Art. V, of the Wisconsin constitution, and Sec. 13.02 Wisconsin Statutes, 1935, regular sessions of the legislature are held in each odd-numbered year. Special sessions of the legislature may be held on call of the governor, at which no business can be transacted except

as shall be necessary to accomplish the special purposes for which it was convened.' A special session was called by the governor in 1933, but for the purposes unrelated to taxation. Proclamations of the Governor of Wisconsin December 2, 28, 1933, January 18, 22, 30, 1934. Thus the legislature in 1935, *at the first opportunity after the tax year in which the income was received*, made its revision of the tax laws applicable to 1933 income, as did Congress in the Joint Resolution of July 4, 1864, commented on in *Stockdale v. Insurance Companies, supra*." [Italics added.]

We feel that the statement of the law as to tax legislation in the case of *Welch v. Henry* is not only reasonable but is the best statement of the law and should be followed in deciding the instant case.

The Government has cited two cases on retroactive legislation: *D. W. Klein Co. v. Commissioner*, 123 F. 2d 871, and *Wilgard Realty Co. v. Commissioner*, 127 F. 2d 514. In the first case the Revenue Act of 1939 provided that it should be effective with respect to the Revenue Act of 1924 and other Revenue Acts. However, at no point in that case was the question of the retroactive nature of the legislation raised. In the latter case the period of retroactivity was about seven years. The court there found that the petitioner had done nothing it would not have done had the law been; when the exchange was made, exactly what the 1939 enactment later made it. The taxpayer was therefore not the victim of any injustice. We believe the present case can be distinguished.

The case at bar differs from all the other cases considered here in that the dissolution of the corporation and payment of tax were made under a section of the Revenue Act of 1938, which by its very terms was effective and operative *only* for the year 1938. This was a special law in order to come within its provisions dissolution of the corporation had to be completed by December 31, 1938. There is no question but that if this section of the Revenue Act of 1938 had been repealed expressly by the Revenue Act of 1939 codifying the Internal Revenue Laws, this 1940 amendment to the 1938 Act would be a mere superfluity. It is impossible to amend a law that no longer exists. It would seem equally unreasonable to permit the amendment of a law after some legislative sessions have passed—where the law by its own terms is no longer effective.

There is no question but that laws, particularly internal revenue laws, can be retroactive. However, the courts have held that there is a point of time when such retroactivity is beyond the legislative power. The rule that such amendment to legislation must come within the next session of the legislation or within a reasonable length of time as analyzed in the *Welch v. Henry* case, 305 U. S. 134, is the sounder law.

There has been some emphasis of the fact that the Revenue Act of 1940 specifically provides that Section 501 (a) shall apply to the Revenue Act of 1938 and other prior acts. We concede that this provision shows a clear intent on the part of the legislature but we believe that if Congress has not the power to pass legislation which does not come within the rule of permissible retroactivity, the fact that the legislation recites it shall be so retroactive does not cure the defect.

Reversed.

(Endorsed.) Opinion Filed May 16, 1944. Paul P. O'Brien, clerk.

Judgment

Upon petition to review a Decision of The Tax Court of the United States.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, It is now here ordered and adjudged by this Court, that the decisions of The Tax Court of the United States in this cause be, and hereby are reversed.

(Endorsed.) Judgment. Filed and entered May 16, 1944. Paul P. O'Brien, Clerk.

Certificate of Clerk, U. S. Circuit Court of Appeals for the Ninth Circuit, to Record Certified Under Rule 38 of the Revised Rules of the Supreme Court of the United States

I, PAUL P. O'BRIEN, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify that the foregoing one hundred and thirty-five (135) pages, numbered from and including 1 to and including 135, to be a full, true and correct copy of the entire record of the above entitled case in the said Circuit Court of Appeals, made pursuant to request of Honorable Charles Fahy, Solicitor General of the United States, counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 21st day of July, 1944.

[SEAL]

PAUL P. O'BRIEN, Clerk.

By FRANK H. SCHMIDT,
Deputy Clerk.

Supreme Court of the United States

Order allowing certiorari

Filed October 16, 1944

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE

Nos. **354**

Office - Supreme Court, U.S.

FILED

AUG 16 1944

CHARLES ELMORE CROPLEY
CLERK

In the Supreme Court of the United States

9 OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

**ELLIOTT H. WHEELER AND ROLLO C. WHEELER,
EXECUTORS OF THE ESTATE OF JOHN H.
WHEELER, DECEASED**

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CORNELIA W. GOOD

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELLIOTT H. WHEELER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FRANCES V. WHEELER

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

YSABEL F. BERLINER

**PETITION FOR WRITS OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE NINTH
CIEGUIT**

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YSABEL F. BERLINER

**PETITION FOR WRITS OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE NINTH
CIRCUIT**

**The Solicitor General, on behalf of the Com-
missioner of Internal Revenue, prays that writs**

of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above causes on May 16, 1944, reversing decisions of the Tax Court of the United States.

OPINIONS BELOW

The findings and opinion of the Tax Court (R. 57-81) are reported at 1 T. C. 640. The opinion of the Circuit Court of Appeals (R. 121-130) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 16, 1944 (R. 130). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayers were stockholders in a corporation which was liquidated in December 1933; the assets were distributed among the stockholders who elected in writing to be taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. The corporation had issued all its capital stock for assorted properties in a non-taxable exchange in 1925 and immediately succeeding years and it subsequently sold the properties so acquired.

1. Whether, in computing the accumulated "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) of the corporation at

the time of its liquidation, the proper basis for determining the earnings and profits which resulted to the corporation from the sale of the properties for which it had issued its stock is the value of the property at the time the corporation acquired it, or is the cost of the property to the transferors, which became the basis for determining the taxable gain or allowable loss of the corporation on the sale or other disposition of the property.

2. Whether Section 501 of the Second Revenue Act of 1940, amending Section 115 of the Revenue Act of 1938 (and the corresponding provision of each preceding Act) as of the date of its enactment, in order to define with certainty the meaning of the statutory term "earnings and profits" of a corporation as used in Section 115, is clarifying legislation or retroactive legislation.

3. Whether, if Section 501 is retroactive legislation, it deprives respondents of property without due process of law.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra*, pp. 21-32. The pertinent Congressional Committee Reports are set forth in Appendix B, *infra*, pp. 33-37.

STATEMENT

John H. Wheeler, now deceased and represented by his executors, and the four other re-

spondents owned 90 percent and Bollo C. Wheeler the remaining shares of the stock of the John H. Wheeler Company, a California corporation, at the time of its liquidation in December 1938.¹ John H. Wheeler and his wife, Francis V. Wheeler, had organized the John H. Wheeler Company in 1925, and, during the years following its organization and until the year 1929, the two organizers received the company's 4,918 shares of stock in consideration of certain securities which they transferred to the corporation. The properties so transferred were worth \$491,800 and had cost the two organizers \$304,688.49. (R. 31-32, 59-60.)

Prior to liquidation, the corporation sold most of the property it had acquired in exchange for its stock upon its organization, and, in accordance with the applicable Revenue Acts (*vis.*, Section 204 (a) (8) of the Revenue Act of 1924 and corresponding provisions of later Acts), it used the basis of its transferors (John H. Wheeler and wife) in computing its taxable gain or allowable loss upon such sales (R. 33, 60). It invested the net proceeds of its operations in assorted securities (see R. 34).

¹ John H. Wheeler lived until June 14, 1939 (R. 36), but, as his executors represent him, they are sometimes referred to herein as "taxpayers." There were five appeals to the Tax Court, one by each of four individuals and one by the estate. The issue being the same in each case, a consolidated record was prepared and used below. (See R. 113-117.)

On December 2, 1938, after giving consideration to the application of Section 112 (b) (7) (E) of the Revenue Act of 1938, the stockholders of the John H. Wheeler Company dissolved the corporation, and all the assets were proportionately distributed in liquidation to the stockholders during December 1938. The assets so distributed consisted of securities having a fair market value of \$624,560¹ and cash in the sum of \$111.84. (R. 34, 61-62.) The stockholders of the Wheeler Company, the fair market value of the securities and the cash which each received in the liquidation, and the basis of their Wheeler Company stock were as follows (R. 60, 63):

	Shares held	Fair market value of cash and securities received in liquidation	Basis of Wheeler Company stock
John H. Wheeler.....	2,450	\$312,335.92	\$153,508.01
Frances V. Wheeler.....	491 $\frac{1}{2}$	62,467.18	30,701.00
Elliott H. Wheeler.....	491 $\frac{1}{2}$	62,467.18	30,701.00
Cornelia W. Good.....	491 $\frac{1}{2}$	62,467.18	30,701.00
Yisael F. Berliner.....	491 $\frac{1}{2}$	62,467.18	30,701.00
Rollo C. Wheeler.....	491 $\frac{1}{2}$	62,467.18	30,701.00
Total.....	4,918	624,671.82	307,010.01

¹ See also R. 24.

² Cf. R. 25.

• While the foregoing table discloses that each of the stockholders realized through the liquidation

³ Of the properties so distributed, only securities worth \$693.87 had been acquired by the John H. Wheeler Company after April 9, 1938. John H. Wheeler's one-half of those securities was worth \$346.94. (R. 24, 35, 64, 78; Cf. R. 50.)

of the Wheeler Company a gain in excess of 100 percent on his investment (see Section 115 (c), Revenue Act of 1938, Appendix A, *infra*, pp. 26-27), respondents desired to have their respective gain recognized and taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938 (Appendix A, *infra*, p. 24). Accordingly, each of the stockholders now before this Court executed (and filed with the Treasury Department) a written election on Treasury Form 964 to have his gain in the liquidation so taxed (R. 35, 63-64). As each of the stockholders had received, among other assets in the liquidation, his pro rata share of securities which the Wheeler Company had acquired after April 9, 1938, and of the distributed cash, each of the present taxpayers reported for income tax purposes his proportionate part of the sum (\$805.71) of these two items (see Statement, *supra*, p. 5, and fn. 2, *ibid.*). Thus, John H. Wheeler, who owned one-half of the liquidating corporation's stock, reported \$402.86 as taxable under Section 112 (b) (7) (E), while each of the other shareholders reported \$80.57 as the amount of his taxable gain (R. 35, 64). Each stockholder treated the Wheeler Company as a deficit corporation and none of them reported any amount in his respective income tax return as a dividend receipt in connection with the liquidation of the John H.

Wheeler Company (i. e., as a distribution out of corporate "earnings and profits" (sec. 112 (b) (7) (E)) accumulated after February 28, 1913) (R. 35-36).

The Commissioner of Internal Revenue concluded that the Wheeler Company was not a deficit corporation and determined that the accumulated "earnings and profits" of the Wheeler Company as of December 2, 1938, amounted to \$132,813.38 (R. 64). Accordingly, although each shareholder had realized a substantially greater gain in the liquidation, the Commissioner determined that, under Section 112 (b) (7) (E), each was taxable on only the amount which he had reported for tax purposes plus his share of the distributed "earnings and profits" of the corporation, and that the latter were received as follows (R. 64):

John H. Wheeler.....	\$36,406.69
Elliott H. Wheeler.....	13,281.38
Frances V. Wheeler.....	13,281.38
Cornelia W. Good.....	13,281.38
Isabel Berlinet.....	13,281.38

The Commissioner determined the earnings and profits of the Wheeler Company at the time of its liquidation by using the cost to John H. Wheeler and his wife of the securities they had previously transferred to the Wheeler Company in exchange for its stock as the cost or basis of those securities to the Wheeler Company. Since such cost was

\$180,314.99³ less than the book figure at which the company had entered those securities in its books and since the corporation's book deficit, computed by the use of its book figures, was \$47,501.61, the undistributed gains, earnings and profits of Wheeler Company at the time of its liquidation were \$132,813.38.⁴ (R. 27, 33, 65.)

The Tax Court adjusted the Commissioner's computation of corporate "earnings and profits" at liquidation by an item of \$5,953.06 (R. 81)—which was not made an issue in the Circuit Court of Appeals, the Commissioner not having taken a cross-appeal—and otherwise sustained the Commissioner's determination. The Circuit Court of Appeals reversed the decision of the Tax Court.

³ The fair market value of all properties which the Wheeler Company acquired for its stock (\$491,800), minus the cost of those properties to the corporation's predecessors in title (\$304,684.49), minus \$6,800.52 (the excess of book value over transferors' cost of original securities unsold at liquidation of Wheeler Company), constitutes the \$180,314.99 (R. 27; cf. R. 33).

⁴ The sum of \$180,314.99 minus \$47,501.61 equals \$132,813.38. A more detailed computation of the Wheeler Company's earnings and profits at liquidation appears at R. 17-18. There is, however, an error of \$1,000 in that computation, since it is undisputed between the parties that, without regard to the \$5,953.06 item mentioned in the last paragraph of this Statement, the Wheeler Company had "earnings and profits" of \$132,813.38 on December 2, 1938, if in determining those "earnings and profits" it must use, as the Government contends, the basis of its two predecessors in title for the properties for which the company had issued all its stock.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that in computing the accumulated "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) of the John H. Wheeler Company, a corporation, at the time of its liquidation, the basis for properties acquired in nontaxable exchanges in consideration of its own stock, and subsequently sold, was the fair market value of the properties at the date the corporation acquired them, rather than the cost of the property to the transferors, which became the corporation's basis for determining its taxable gain or allowable loss on the sale or other disposition of the properties.

2. In holding that Section 501 of the Second Revenue Act of 1940, amending Section 115 of the Revenue Act of 1938 (and the corresponding sections of prior Revenue Acts) as of the date of its enactment, is retroactive and not clarifying legislation.

3. In holding that Section 501 is unconstitutional as applied to this case because of objectionable retroactivity.

4. In reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The Circuit Court of Appeals has erroneously decided a question of far-reaching importance in the administration of the revenue

laws. It has conceded that Section 501 of the Second Revenue Act of 1940 (Appendix A, *infra*, pp. 27-29) is in terms applicable but has held the enactment invalid as applied to this case. The basis for its decision is that the provision, which was designated and designed by Congress as clarifying legislation to resolve any possible obscurity in the meaning of the statutory term corporate "earnings or profits," used in Section 115 of the Internal Revenue Code (Appendix A, *infra*, pp. 25-27), and in all preceding Revenue Acts,* was not clarifying legislation, but was new legislation which changed existing law and undertook to change retroactively the meaning of the statutory phrase corporate "earnings or profits" as used in Section 115 of the Revenue Act of 1938 (and the corresponding provision of preceding Acts) and that it served to deprive the several taxpayers of property without due process of law.

Since the adoption of the Sixteenth Amendment, all the Revenue Acts have included "dividends" in the gross income of individuals which,

* See Section 201 (a) of the Revenue Acts of 1918, c. 18, 40 Stat. 1057; 1921, c. 136, 42 Stat. 227; 1924, c. 234, 43 Stat. 253; Section 115 (a) of the Revenue Acts of 1928, c. 852, 45 Stat. 791; 1932, c. 209, 47 Stat. 169; 1934, c. 277, 48 Stat. 680; 1935, c. 630, 49 Stat. 1648, and 1938.

Section 115 (c), which is involved here, refers to Section 112. The Commissioner determined respondents' tax under subparagraph (b) (7) (E) of Section 112, in accordance with respondents' election to be taxed thereunder (see Statement, *supra*, pp. 5-6). The Committee reports (Appendix B, *infra*, pp. 33-37) reveal that Congress intended Section 501 to apply to Section 112, as the courts below recognized.

less deductions, is subject to tax. All Revenue Acts from that of 1918 (Section 201 (a) thereof) to and including Section 115 (a) of the Internal Revenue Code, have defined the term, "dividends" as any distribution made by a corporation, whether in cash or other property, out of its "earnings or profits" accumulated since February 28, 1913. In time Congress provided that no gain or loss should be recognized upon the transfer of property to a corporation by persons in exchange for the corporation's stock, where immediately after the exchange the transferors were in control of the corporation,* and then to prevent evasions[†] provided that the basis to the corporation for property so acquired after December 31, 1920, should be the same as it would be in the hands of the transferor, adjusted by the amount of any gain or loss recognized to the transferor under the law applicable to the year of the transfer.[‡]

Eventually some taxpayers raised the question whether a corporation's basis, for determining its "earnings or profits" upon the sale or other dis-

* See, e. g., Section 202 (c) (3), Revenue Act of 1921; Section 203 (b) (4), Revenue Act of 1924; Section 112 (a) (5), Internal Revenue Code.

† See, e. g., Section 204 (a) (8), Revenue Acts of 1924 and 1926, c. 27, 44 Stat. 9; Section 113 (a) (8), Internal Revenue Code.

‡ Thus, the basis to the John H. Wheeler Company for the properties acquired from Wheeler and his wife in exchange for the company's stock was \$304,684.49, although the properties were worth \$491,800. (See R. 27.)

position of property for which it had issued its stock, was the same as the corporation's basis for determining its gain or loss from the particular sale or disposition of the property. To resolve any possible obscurity on this point the Treasury Department covered it by regulation. Article 115-1, Treasury Regulations 86, relating to the Revenue Act of 1934, provided:

Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized [for tax purposes] under that section.

The same provision was repeated under subsequent Regulations which implemented like provisions of the subsequent Revenue Acts.* That regulation had not been held invalid by any tribunal either at the time the John H. Wheeler Company was liquidated" or at the time of the

* See Article 115-3, Treasury Regulations 94 (1936 Act), and Treasury Regulations 101 (1938 Act); Section 19.115-3 of Treasury Regulations 103, and Section 29.115-3 of Regulations 111, promulgated under the Internal Revenue Code.

" In *F. J. Young Corp. v. Commissioner*, 35 B. T. A. 860 (decided in 1937), a case in which the regulation was not involved, it was held that a "gain" which resulted from a tax-free exchange of securities should be considered as "earnings or profits" out of which a dividend, within the meaning of Section 115 of the Revenue Act of 1928, could be paid. This decision was affirmed in 1939 (between the date of the liquidation of the Wheeler corporation and the passage of the Second Revenue Act of 1940). *Commissioner v. F. J. Young Corp.*, 103 F. 2d 137 (C. C. A. 3rd). See also *W. S. Farish & Co. v. Commissioner*, 38 B. T. A. 150, decided by

enactment of the Second Revenue Act of 1940.¹¹

The stockholders of the John H. Wheeler Com-

the Board in 1938, affirmed in 1939 (*Commissioner v. W. S. Farish & Co.*, 104 F. 2d 833 (C. C. A. 5th)), in which the regulation was not mentioned.

Some of the earlier Board of Tax Appeals decisions cited by the Circuit Court of Appeals (fn. 3 to opinion), however, are largely irrelevant to the present case. *E. g.*, *Ayer v. Commissioner*, 12 B. T. A. 284, was decided in favor of the Government in 1928. There the Board held that a 1922 distribution out of a corporation depletion reserve, based upon a discovery value which exceeded cost or March 1, 1913, value, was a distribution out of corporate "earnings or profits" accumulated since March 1, 1913, and was therefore taxable as a dividend to stockholders. See also *Weyerhaeuser v. Commissioner*, 33 B. T. A. 594. At most, a few of these cases suggest the inference that in a proper case the Board of Tax Appeals might disagree with the Commissioner's view set forth in the 1934, 1936, 1938, and subsequent Treasury Regulations.

¹¹ Except for the instant case, this Treasury Regulation has not been held invalid by any appellate court since the liquidation of the Wheeler corporation.

In *Estate of Fred J. Fisher v. Commissioner*, decided February 9, 1944 (1943-1944 Tax Court Memorandum Decisions Service, par. 44,034), the Tax Court held that the basis, in cases pending before the Board of Tax Appeals or any court of the United States on September 30, 1940, for determining corporate earnings and profits from the sale of property which the corporation had acquired in a tax-free transaction was the market value of the property at the date the corporation acquired it. The Commissioner, however, on June 22, 1944, filed a petition for a review of that decision of the Tax Court by the United States Circuit Court of Appeals for the Sixth Circuit. The case involves that portion of Section 501 (c), not involved here, which provides that cases pending on September 30, 1940, shall not be affected. See pp. 28-29, *infra*, and the Senate Committee Report, p. 37, *infra*.

pany liquidated their corporation in December 1938, charged with knowledge of the applicable Treasury Regulations, which they chose to disregard in making their returns.

By Section 501 of the Second Revenue Act of 1940, Congress specifically endorsed and confirmed the Commissioner's position set forth in the Treasury Regulations for some years. The Circuit Court of Appeals conceded (R. 130) that the statutory language showed a clear intent on the part of Congress to make the amendment applicable to the 1938 Act.¹¹ Although the Committee Reports which accompanied the drafts of the legislation specifically stated that the added statutory language is clarifying in purpose (see Appendix B, *infra*, pp. 33, 34, 35), the Circuit Court of Appeals disregarded the Congressional declaration of purpose upon the theory that the declaration "was eliminated before its passage."

The court has seriously confused the Congressional Committee Reports with the drafts of the Act. None of the drafts of what became Section 501 ever contained any statement that the purpose of the amendment was "to clarify the law;"

¹¹ Respondents may assert, as they did below, that the effective date of Section 501 is ambiguous. However, the effective date of paragraph (b) of Section 501 was inserted to make it clear that the amendment to the Internal Revenue Code was effective as of the effective date of the Code, while paragraph (c) extended the effective date to prior Revenue Acts outside the Code itself. (See S. Rep. No. 2114, 76th Cong., 3d sess., Appendix B, *infra*, pp. 36-37.)

that language appeared in the Committee Reports, and it remains in those reports and characterizes the amendment as clarifying. Such a declaration of Congressional purpose should be conclusive. *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, 322; cf. *Helvering v. N. Y. Trust Co.*, 292 U. S. 455, 468-469; *Commissioner v. Bristol*, 121 F. 2d 129, 135 (C. C. A. 1st). A judicial rejection of such a declaration jeopardizes most other clarifying amendments to the many other sections of the various revenue laws where, as with Section 501 of the Second Revenue Act of 1940, the declaration of Congressional purpose appears only in the Committee Reports. Moreover, the practical effect of the decision below will be to require disputed questions of interpretation of the revenue laws to be brought to this Court for settlement in each instance without the possibility of going to Congress for a clarifying enactment applicable to prior years. This result would mark a most unfortunate step in the relationship of the three branches of Government with respect to enforcement of the tax laws.

2. The Circuit Court of Appeals has held an Act of Congress (Section 501 of the Second Revenue Act of 1940) enacted in exercise of its legislative powers to levy and collect taxes, to be unconstitutional as respects these several tax-

payers. The principle of the decision is broad enough to cover all taxpayers similarly situated, and also, it would seem, all stockholders of any corporation who received distributions from their corporation before the tax year 1939, whether or not in the month of December 1938, and whether or not the distribution was one in complete or in partial liquidation of the corporation. Such a denial of legislative power justifies an exercise by this Court of its power of judicial supervision and review.

3. Treated *arguendo* as retroactive legislation, Section 501 of the Second Revenue Act of 1940 does not violate the principle of permissible retroactivity¹¹ in the amendment of revenue laws, and the Circuit Court of Appeals erred in holding otherwise. Its decision that the legislation is so objectionably retroactive that it offends the due process clause of the Fifth Amendment conflicts in principle with the decisions of other Circuit Courts of Appeals upholding legislation which is retroactive and not merely clarifying in nature, and is in essential conflict with decisions of this Court upholding retroactive income tax legislation.

¹¹ Actually, Section 501 did not impose a tax upon a transaction, the gains of which were not taxable in 1938, but, still assuming that Section 501 was not clarifying but retroactive, reduced the amount of the postponement benefit for the year 1938 which the taxpayers thought they could obtain under Section 112 (b) (7) (E) of the 1938 Act. (See Sections 111, 112 (a), 115 (c), and 117 (b), Revenue Act of 1938.)

The Second Revenue Act of 1940 was passed on October 8, 1940. The stockholders of the John H. Wheeler Company had dissolved their corporation during December 1938. The Circuit Court of Appeals assumed that *Welch v. Henry*, 305 U. S. 134, stood for the arbitrary rule that an income tax provision cannot be applied retroactively to a year prior to that succeeding the year of the last previous general session of Congress. We do not so construe that decision. It does not lay down any general rule as to the permissible retroactivity of income tax statutes. In that case, the Court sustained an act of the Wisconsin Legislature passed March 27, 1935, imposing a tax on corporate dividends of a certain type which residents of Wisconsin had received in 1933. The Wisconsin Act was unquestionably retroactive legislation." The Legislature had passed it at its first general session after 1933, and the Court called attention to such circumstance but quite without statement or intimation that an income tax law, retroactive for a longer period, is *per se* invalid."

"Had the Wisconsin Act been "a remedial measure to ratify a doubtful administrative interpretation of prior legislation" (see *Welch v. Henry*, *supra*, p. 158), it seems apparent there would have been no dissent in the *Welch* case.

"See also *Coopers v. United States*, 280 U. S. 409; *United States v. Hudson*, 299 U. S. 498; cf. *Mulliken v. United States*, 283 U. S. 15; *Illinois Central R. Co. v. Minnesota*, 309 U. S. 157, 164-165.

The decision below also conflicts in principle with *D. W. Klein Co. v. Commissioner*, 123 F. 2d 871 (C. C. A. 7th), certiorari denied, 315 U. S. 819," and *Wilgard Realty Co. v. Commissioner*, 127 F. 2d 514 (C. C. A. 2d), certiorari denied, 317 U. S. 655. Those cases arose under the provisions of the Revenue Act of 1932 as retroactively amended by Section 213 (f) (1) of the Revenue Act of 1939, c. 248, 53 Stat. 862, and, in both cases, the 1939 amendment was held effective to change the law as to transactions occurring in 1932. (See also *Commissioner v. Corpus Christi T. Co.*, 126 F. 2d 898 (C. C. A. 5th).)

The *Wilgard Realty Co.* case cannot be distinguished upon the ground that there the retroactive legislation was no more burdensome than the taxpayer should have expected when he accomplished the thing creating the tax liability, for the respondents must be deemed to have liquidated their corporation with knowledge of the regulations (Article 115-3 of Treasury Regulations 94 and 101, Appendix A, *infra*, pp. 31-32). The House Committee Report on Section 501 declares that taxpayers had generally concurred in the rule ap-

"The court below sought to distinguish the instant case from the *D. W. Klein Co.* case upon the assumed ground (R. 129) that "at no point in that case was the question of the retroactive nature of the legislation raised." The court was not informed upon the point; the *D. W. Klein Company* did challenge the retroactive amendment as contravening the due process clause of the Fifth Amendment, and its brief in the Circuit Court of Appeals (pp. 11-12, 51-52) so shows.

plied by the Treasury. See p. 34, *infra*. Furthermore, the effect of Section 501, as applied to respondents, was merely to reduce and not to eliminate a benefit which each of them received by electing to be taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. They still gained an advantage from their election," and it may not be assumed that they would not have liquidated their corporation in December 1938, or have elected to be taxed under Section 112 (b) (7) (E) if they had anticipated the enactment of Section 501 of the Second Revenue Act of 1940. Consequently, the taxpayers here were not injured in the constitutional sense when the amendment, whether clarifying or retroactive, made it clear that their personal holding company was not entitled to a "stepped-up" basis for determining its earnings and profits from the sale of property for which the corporation had merely issued its stock.

" This is illustrated by the case of John H. Wheeler. Under Section 111 (a) (b) of the Revenue Act of 1938, Appendix A, *infra*, p. 21, he realized a gain of \$158,830.91 (\$312,335.92 minus \$153,505.01) upon the liquidation of his corporation (R. 60, 63). (The actual gain was \$159,177.85 as the Tax Court noted (R. 78, cf. R. 24).) If the profits so realized had been taxed otherwise than under Section 112 (b) (7) (E), 50 percent of Wheeler's gain, or \$79,588.93, would have been taxed. Section 115 (c) and 117 (b) of the Revenue Act of 1938. The amount which the Commissioner proposed to tax Wheeler under Section 112 (b) (7) (E), was \$66,809.55 (R. 25), reduced by the Tax Court to \$63,833.02 (R. 78-81).

It should be noted that the statutory provision here condemned is not a one-way enactment. The availability of earnings or profits, or the want thereof, will operate to the advantage or disadvantage of the taxpayer, depending upon the circumstances confronted. A position contrary to that taken by the Treasury with Congressional approval would result in larger taxes in many situations. Thus, for example, earnings and profits available for dividends are minimized for tax purposes, under the Government's position, where there is a corporate gain on reorganization, unrecognized for tax purposes, and the property therein acquired has not been sold. See Paul, *Studies in Federal Taxation, Second Series*, 149, 185-199. This feature of the Treasury's position confirms its fairness and that of Section 501 of the Second Revenue Act of 1940.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that these petitions should be granted.

CHARLES FAHY,
Solicitor General.

AUGUST 1944.

APPENDIX A

Revenue Act of 1938, c. 289, 52 Stat. 447:

TITLE I—INCOME TAX

SUBTITLE C—SUPPLEMENTAL PROVISIONS

Supplement B—Computation of Net Income

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of

the gain or loss, determined under section 111, shall be recognized, except as herein-after provided in this section.

(b) *Exchanges Solely in Kind.*—

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(7) *Election as to Recognition of Gain in Certain Corporate Liquidations.*—

(A) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before, or after January 1, 1938; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December, 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the

extent provided in subparagraphs (E) and (F).

(B) *Excluded Corporation.*—The term “excluded corporation” means a corporation which at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 per centum or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(C) *Qualified Electing Shareholders.*—The term “qualified electing shareholder” means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D), but—

(i) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 per centum of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; * * *

(D) *Making and Filing of Elections.*—The written elections referred to in subparagraph (c) must be made and filed in such manner as to be not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary.

The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) *Noncorporate Shareholders*.—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938, and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

• • • • •
SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property*.—The basis of property shall be the cost of such property; except that—

• • • • •
 (8) *Property Acquired by Issuance of Stock or as Paid-in Surplus*.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including,

also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

(b) *Adjusted Basis*.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend*.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions*.—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently

accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two

years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

Each of the above sections of the Revenue Act of 1938 was carried into the corresponding section of the Internal Revenue Code passed February 10, 1939, except subparagraph (7) of Section 112 (b), *supra*, pp. 22-24.

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

“(1) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

“(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made),

for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. * * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which,

on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

(26 U. S. C., Sec. 115.)

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 112 (b) (7)-1. *Corporate liquidations in December, 1938.*—(a) *General.*—Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within the month of December, 1938, for the treatment of gain on the shares of stock owned by qualified electing shareholders on the date of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be recognized, and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and article 112 (b) (7)-2. For the basis of property received on such liquidations, see section 113 (a) (18).

(b) *Type of liquidation.*—The liquidation must be in pursuance of a plan of liquidation adopted after May 28, 1938. * * *

If a transaction constitutes a distribution in complete liquidation within the

meaning of the Act and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

ART. 112 (b) (7)—4. Treatment of gain.—

(a) *Computation of gain.*—As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 115 (c), and gain from the receipt of such amounts is determined, as provided in section 111. . . .

(b) *Recognition of gain.*—Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following—

(1) Such share's ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, computed as of December 31, 1938, without diminution by reason of distributions made during the month of December, 1938; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after April 9, 1938. . . .

(c) *Treatment of recognized gain.*—In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned on the date of the adoption of the plan of liquidation which is not in excess of its

ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section 112 (b) (7) (E) (i) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated and taxed to him as a short-term or long-term capital gain, as the case may be. * * *

ART. 115-2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. * * *

ART. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses

are recognized under that section.¹ Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * *

ART. 115-5. Distributions in liquidation.—(a) *General.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

* * * * *

¹ This sentence appears in the regulations promulgated under preceding Revenue Acts: Article 115-3, Treasury Regulations 94 (1936 Act); Article 115-1, Treasury Regulations 86 (1934 Act). The same sentence appears in the Treasury Regulations promulgated under the Internal Revenue Code: Sec. 19.115-3, Treasury Regulations 103 and Sec. 29.115-3, Treasury Regulations 111. See, also, Sections 19.115-12 and 29.115-12 of the same Regulations.

APPENDIX B

COMMITTEE REPORTS

THE SECOND REVENUE BILL OF 1940

H. Rep. No. 2894, 76th Cong., 3rd Sess., p. 41
(1940-2 Cum. Bull. 496, 526-527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (1) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner v. Sansome* (60 Fed. (2d), 931) and following decisions, the rule effectuates the provisions of section 112.

While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X Corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was \$100. The fair market value of the stock in the Y Corporation received by the X Corporation was \$1,000. On April 9, 1930, the X Corporation declared a cash dividend of \$900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, \$900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner v. F. J. Young Corporation*, 103 Fed. (2d), 137). Under the proposed legislation and Treasury practice, the \$900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

It should be noted that the provisions of section 401 are applicable only in deter-

mining the earnings or profits for periods beginning after February 28, 1913. * * *

S. Rep. No. 2114, 76th Cong., 3rd Sess., pp. 22, 26 (1940-2 Cum. Bull. 528, 545-548) :

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS.

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. * * *

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code. * * * For example, on January 1, 1939, the X Corporation owned stock in the Y Corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was \$100. The fair market value of the stock in the Y Corporation when received by the X Corporation was \$1,000. On April 9, 1939, the X Corporation declared a cash dividend of \$900 and, except for the possible effect of the transaction in 1938, had no ac-

cumulated earnings or profits. The excess of the fair market value of the stock of the Y Corporation over the basis, \$900, was not recognized gain under the provisions of section 112 of the Revenue Act of 1938. Accordingly, its earnings and profits are not increased by \$900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of \$28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was \$247,000; and that the corporation, after three years' operations, effected in 1927 a cash distribution to X in the amount of \$165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of \$28,000 established in the nontaxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

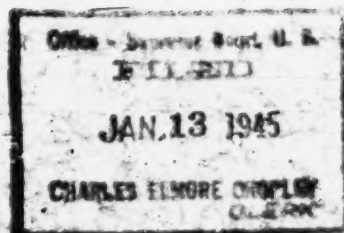
* * * *

The amendments to the Internal Revenue Code made by section 501 (a) are by section 501 (c) made applicable to all prior Revenue Acts, effective as if they were a part of such Act on the date of its enactment, thus effecting the application

of a uniform rule for the determination of the earnings and profits of all corporations for all prior taxable years. The last sentence of the subsection provides that only the actual tax liability of a shareholder taxpayer for a particular year which is now pending before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall remain unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination the provisions of section 501 govern. Section 501 will therefore control for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

* * * *

FILE COPY



No. 854

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

**ERLETT H. WHEELER, ET AL., EXECUTORS OF THE
ESTATE OF JOHN H. WHEELER, DECEASED, ET AL.**

**ON WRIT OF HABEAS CORPUS TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE NINTH CIRCUIT**

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 354

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELLIOTT H. WHEELER, ET AL., EXECUTORS OF THE
ESTATE OF JOHN H. WHEELER, DECEASED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings and opinion of the Tax Court (R. 57-81) are reported in 1 T. C. 640. The opinion of the Circuit Court of Appeals (R. 121-130) is reported in 143 F. 2d 162.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 16, 1944 (R. 130). The petition for certiorari was filed on August 16, 1944, and was granted on October 16, 1944 (R. 131). The jurisdiction of this Court rests upon Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayers were stockholders in a corporation which was liquidated in December 1938; the assets were distributed among the stockholders who, elected in writing to be taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. The corporation had issued all its capital stock for assorted properties in nontaxable exchanges in 1925 and immediately succeeding years, and prior to the liquidation had sold most of the properties so acquired. The questions are:

1. Whether, under the Revenue Act of 1938 as originally enacted and Article 115-3 of Treasury Regulations 101, the proper basis for determining the "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) which resulted to the corporation from the sale of the properties for which it had issued its stock is the value of the properties at the time of acquisition by the corporation, or is the cost of the properties to the transferors, the latter being the basis expressly fixed by Article 115-3.

If it should be determined that Article 115-3 of Treasury Regulations 101 is valid and that for that reason the proper basis is the cost of the properties to the transferors, no further questions are presented. If, however, it should be

determined that unless effect be given to the amendment made to Section 115 of the Revenue Act of 1938 by Section 501 of the Second Revenue Act of 1940, the proper basis is the value of the properties at the time of acquisition by the corporation, then the further question is presented:

2. Whether the application here of Section 501 deprives respondents of property without due process of law in contravention of the Fifth Amendment.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra*, pp. 48-60. Excerpts from the pertinent Congressional Committee Reports are set forth in Appendix B, *infra*, pp. 61-66.

STATEMENT

John H. Wheeler, now deceased and represented by his executors, and the four other respondents owned 90 percent, and Rollo C. Wheeler owned the remaining shares, of the stock of the John H. Wheeler Company, a California corporation, at the time of its liquidation on December 2, 1938.¹ John H. Wheeler and his wife, Frances V.

¹ John H. Wheeler lived until June 14, 1939 (R. 36), but, as his executors represent him, they are referred to herein as "taxpayers". There were five appeals to the Tax Court, one by each of the four individuals and one by the estate. The issue being the same in each case, a consolidated record was prepared and used below. (See R. 113, 117.)

Wheeler, had organized the John H. Wheeler Company in 1925, and, during the years following its organization and until the year 1929, the two organizers received the company's 4,918 shares of stock in consideration of certain securities which they transferred to the corporation. The properties so transferred had cost the two organizers \$304,683.49, but were worth on the dates of exchange an aggregate fair market value of \$491,800, and the corporation set up upon its books the higher figure as the basis of these properties. (R. 31-33, 59-60.)

Prior to liquidation, the corporation had sold most of the securities it had so acquired in exchange for its stock and, in accordance with the applicable Revenue Acts (*viz.*, Section 204 (a) (8) of the Revenue Act of 1924 and corresponding provisions of later Acts), it used the basis of its transferors (John H. Wheeler and wife) in computing its taxable gain or allowable loss upon such sales (R. 33, 60). It invested the net proceeds of its operations in assorted securities (see R. 34).

On December 2, 1938, after giving consideration to the application of Section 112 (b) (7) (E) of the Revenue Act of 1938, the stockholders of the John H. Wheeler Company dissolved the corporation, and all the assets were proportionately distributed in liquidation to the stockholders during December 1938. The assets so distributed consisted of securities having a fair market value

of \$624,560² and cash in the sum of \$111.84. (R. 34, 61-62.) The stockholders of the Wheeler Company, the fair market value of the securities and the cash which each received in the liquidation, and the basis of their Wheeler Company stock were as follows (R. 60, 63):

	Shares held	Fair market value of cash and securities received in liquidation	Basis of Wheeler Company stock
John H. Wheeler	2,459	\$312,335.92	\$153,505.01
Frances V. Wheeler	491 $\frac{1}{2}$	62,467.18	30,701.00
Elliott H. Wheeler	491 $\frac{1}{2}$	62,467.18	30,701.00
Cornelia W. Good	491 $\frac{1}{2}$	62,467.18	30,701.00
Ysabel F. Berliner	491 $\frac{1}{2}$	62,467.18	30,701.00
Rollo C. Wheeler	491 $\frac{1}{2}$	62,467.18	30,701.00
Total	4,918	\$624,671.82	\$307,010.01

While the foregoing table discloses that each of the stockholders realized through the liquidation of the Wheeler Company a gain in excess of 100 percent on his investment (see Section 115 (c), Revenue Act of 1938), each desired to have his respective gain recognized and taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. Accordingly, each of the stockholders now before this Court executed (and filed with the Treasury Department) a written election on Treasury Form 964 to have his gain in the liquidation so taxed. (R. 35, 63-64.)

² Of the properties so distributed, only securities worth \$693.87 had been acquired by the John H. Wheeler Company after April 9, 1938. John H. Wheeler's one-half of these securities was worth \$346.94. (R. 24, 55, 64.)

As each of the stockholders had received, among other assets in the liquidation, his pro rata share of securities which the Wheeler Company had acquired after April 9, 1938, and of the distributed cash, each of the present taxpayers reported as long term capital gain under Section 112 (b) (7) (E) (ii) his proportionate part of the sum (\$805.71) of those two items (see Statement, *supra*, p. 5 and footnote 2). Thus, John H. Wheeler, who owned one-half of the liquidating corporation's stock, reported \$402.86 as taxable under Section 112 (b) (7) (E), while each of the other shareholders reported \$80.57 as the amount of his taxable gain. (R. 35, 64.) Each stockholder treated the Wheeler Company as a deficit corporation and none of them reported any amount in his respective income tax return as a dividend receipt in connection with the liquidation of the John H. Wheeler Company (*i. e.*, as a distribution out of the corporation's "earnings and profits" (sec. 112 (b) (7) (E) (i)). (R. 35-36.)

The Commissioner of Internal Revenue concluded that the Wheeler Company was not a deficit corporation and determined that the accumulated "earnings and profits" of the Wheeler Company as of December 2, 1938, amounted to \$132,813.38 (R. 64). Accordingly, although each shareholder had realized a substantially greater gain in the liquidation, the Commissioner determined that, under Section 112 (b) (7) (E),

each was taxable on only the amount which he had reported for tax purposes plus his share of the distributed "earnings and profits" of the corporation, and that the latter were received as follows (R. 64):

John H. Wheeler.....	\$86,406.00
Elliott H. Wheeler.....	13,281.38
Frances V. Wheeler.....	13,281.38
Cornelia W. Good.....	13,281.38
Ysabel F. Berliner.....	13,281.38

The Commissioner determined the earnings and profits of the Wheeler Company at the time of its liquidation by using as the basis to the Company for the securities which it had acquired from John H. Wheeler and wife in exchange for its own stock and which it had subsequently sold, the cost of those securities to the Wheelers, the transferors. Since such cost was \$180,314.99³ less than the book figure at which the company had entered those securities in its books and since the corporation's book deficit, computed by the use of its book figures, was \$47,501.61, the undistributed gains, earnings and profits of Wheeler Company at the time of its liquidation were \$132,813.48.⁴ (R. 33-34, 65.)

³ The fair market value of all properties which the Wheeler Company acquired for its stock (\$491,800), minus the cost of those properties to the corporation's predecessors in title (\$304,684.49), minus \$6,800.52 (the excess of book value over transferors' cost of original securities unsold at liquidation of Wheeler Company), constitutes the \$180,314.99 (R. 27).

⁴ The sum of \$180,314.99 minus \$47,501.61 equals \$132,813.38. A more detailed computation of the Wheeler Company's earnings and profits at liquidation appears in the Record (pp. 17-18). There is, however, an error of \$1,000

The Tax Court adjusted the Commissioner's computation of corporate "earnings and profits" at liquidation by an item of \$5,953.06 (R. 81)—which was not made an issue in the Circuit Court of Appeals, the Commissioner not having taken a cross-appeal—and otherwise sustained the Commissioner's determination (R. 58-81). The Circuit Court of Appeals reversed the decision of the Tax Court (R. 121-130).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that in computing the accumulated "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) of the John H. Wheeler Company, a corporation, at the time of its liquidation, the basis for properties acquired in nontaxable exchanges in consideration of its own stock, and subsequently sold, was the fair market value of the properties at the date the corporation acquired them, rather than the cost of the property to the transferors, which became the corporation's basis for determining its tax-
in that computation, since it is undisputed between the parties that, without regard to the \$5,953.06 item mentioned in the last paragraph of this Statement, the Wheeler Company had "earnings and profits" of \$132,813.38 on December 2, 1938, if in determining those "earnings and profits" it must use, as the Government contends, the basis of its two predecessors in title for the properties for which the company had issued all its stock.

able gain or allowable loss on the sale or other disposition of the properties.

2. In holding that Section 501 of the Second Revenue Act of 1940, amending Section 115 of the Revenue Act of 1938 (and the corresponding sections of prior Revenue Acts) as of the date of its enactment, is retroactive and not clarifying legislation.

3. In holding that Section 501 is unconstitutional as applied to this case because of objectionable retroactivity.

4. In reversing the decision of the Tax Court.

SUMMARY OF ARGUMENT

For the purpose of computing the earnings and profits of the Wheeler Company at the time of its liquidation, the Commissioner correctly ascribed to the properties which the company had received from Mr. and Mrs. Wheeler in tax-free exchanges for its own stock, the basis which those properties had in the hands of the Wheelers, the transferors.

I

The method which the Commissioner has used here for the determination of "earnings and profits" is correct since it is predicated upon a proper construction of the Revenue Act of 1938 as originally enacted. Not only do the words of the statute support that result, but it is supported by a regulation dealing expressly with the point.

This regulation cannot be said to adopt an unreasonable interpretation of the law and it is therefore valid. Moreover, it represents a long-continued, consistent administrative construction under a series of statutes containing the same language, and ultimately was expressly approved by Congress; it should therefore be deemed to have acquired the force and effect of law.

II

A. The Commissioner's treatment is indisputably correct under Section 501 of the Second Revenue Act of 1940. That Section is by its terms applicable to tax liabilities for the year 1938, and its legislative history unambiguously declares that it was intended to be so applied.

B. (1) No constitutional objection can be based upon the fact that Section 501 reaches into the past, for it merely resolved a doubt which had arisen in the administration of the preexisting law. From the time of the Revenue Act of 1934, the Treasury Regulations had consistently interpreted the statutes in accordance with the rules subsequently declared by Section 501. Although these Regulations had not been declared invalid either by the Board of Tax Appeals or by any court, two decisions of Circuit Courts of Appeals in 1939, affirming decisions of the Board of Tax Appeals rendered in 1937 and 1938, did cast doubt upon the validity of the administrative interpretation. *Commissioner v. F. J. Young Corp.*, 103

F. 2d 137 (C. C. A. 3d); *Commissioner v. W. S. Farish & Co.*, 104 F. 2d 833 (C. C. A. 5th). In the year following these decisions, Congress, having made an express finding that the need for certainty made it desirable to clarify the existing law, enacted Section 501 as a ratification and confirmation of the prior administrative construction. Not only is there nothing in the Fifth Amendment which can be said to proscribe such action by the legislative branch of the Government, but it is a practice which should be encouraged. It affords a method of putting to rest troublesome questions arising out of the administration of complex statutory provisions with a speed that can hardly be matched by attempted solution by way of final judicial decisions. It thus avoids long periods of uncertainty and confusion, with resulting benefits to taxpayers and to the courts, as well as to those charged with the duty of administering the law. Moreover, the very nature of the judicial process means that a single decision can settle only a comparatively narrow portion of a problem which may, and usually does, have many ramifications. The legislative process, however, is free from these intrinsic limitations which inhere in the judicial process; the former is a method which is not limited to the confines of a single controversy, either in acquiring the information upon which to act or in providing a solution.

The taxpayers' objection to the application here of Section 501 rests upon the assertions (a) that at the time of the dissolution of the corporation, December 2, 1938, the "law" sanctioned the method which they urge for computing "earnings and profits", and (b) that they relied upon that "law" in liquidating the company.

(a) In December of 1938, the law upon the point was unsettled and there was no basis upon which anyone could justifiably have relied upon the decisions of the Board of Tax Appeals in the *Young* and *Farish* cases. These cases were themselves then under challenge by the Government in the Circuit Courts of Appeals, and in addition there was ample other public notice that it was the Government's position that the Board's view was erroneous.

(b) There is no evidence, and the Tax Court has expressly refused to find, that the taxpayers did in fact rely upon those early Board decisions and would not otherwise have liquidated the corporation.

(2) Even if Section 501 should be treated as effecting a retroactive change in the law, it is nevertheless not unconstitutional. Retroactivity does not spell unconstitutionality and we know of no case holding invalid a provision of any federal income tax on the ground that it violated the Fifth Amendment. The power of Congress to make retroactive changes in the internal

structure of the income tax law is confirmed by a quarter of a century of history of such practice, and aside from the decision here under review, by the decision in every case in which an objection upon the score of retroactivity has been raised.

ARGUMENT

Introductory.—On December 2, 1938, the Wheeler Company was liquidated pursuant to Section 112 (b) (7) of the Revenue Act of 1938 (Appendix A, *infra*, pp. 49-51) which provided an elective method for taxing stockholders upon the liquidation of a corporation. Under this method each shareholder was to be taxed only upon that portion of the gain realized in the liquidation which represented the shareholder's ratable share of the corporation's accumulated "earnings and profit" (sec. 112 (b) (7) (E)). Recognition and taxation of the balance of the gain³ realized upon the liquidation was to be postponed until the property received was disposed of by the shareholders. See Section 113 (a) (18) (Appendix A, *infra*, p. 52).

The issue herein arises with respect to the correct basis to be used for determining "earnings

³ Except for that portion representing cash, or securities acquired by the liquidating corporation after April 9, 1938, and this portion was to be taxed as capital gain. Section 112 (b) (7) (E) (ii). In the present case the corporation distributed cash and such securities in a total of \$805.71 (R. 35, 64). There is no dispute between the parties with respect to the taxation of this item.

and profits" realized by the Wheeler Company upon its disposition (prior to the liquidation) of the securities which it had acquired in tax-free exchanges for its own stock. The taxpayers contend that for the purpose of computing the amount of "earnings and profits" realized by the corporation upon the disposition of these assets, the basis should be their value when acquired by the corporation, \$491,800. The Commissioner, on the other hand, contends, as he appears consistently to have contended in all similar cases, that the same basis must be used for the determination of earnings and profits as is used for the determination of taxable gain or allowable loss to the corporation, i. e., \$304,683.49, the cost of these securities to the corporation's transferors, Mr. and Mrs. John H. Wheeler.

Section 501 (a) of the Second Revenue Act of 1940 (Appendix A, *infra*, pp. 54-56) makes it clear that the Commissioner's position is correct, for it provides expressly that "earnings and profits" shall be determined by taking the same basis as that which is applicable for determining gain or loss in computing net income. And subsection (c) of Section 501 directs that the provisions of subsection (a) shall "for the purposes of the Revenue Act of 1938 or any prior Revenue Act * * * be effective as if they were a part of each such Revenue Act on the date of its enactment." The court below has held, however, that application of these provisions of the Second Revenue Act of

1940 offends the due process clause of the Fifth Amendment and in so holding seems to have assumed that the effect of Section 501 was to make a radical alteration in the prior law and that it was therefore strictly retroactive legislation.

If, as we contend, the basis used by the Commissioner is correct under the law as it stood prior to the enactment of Section 501, it will be unnecessary to consider the constitutional question. If, however, the Court should reach the question of the constitutional validity of the application of Section 501, then we respectfully submit that in no view of the case should it be held that, as here applied, the Section is unconstitutional. It does not constitute retroactive legislation in any true sense, for its purpose and effect was merely to clarify a doubtful point which had arisen under the existing law. And even if the amendment be treated as effecting a sharp change in the prior law and therefore truly retroactive, it is nevertheless not unconstitutional.

I

REGARDLESS OF SECTION 501, THE BASIS USED BY THE COMMISSIONER FOR THE DETERMINATION OF "EARNINGS AND PROFITS" IS CORRECT

We submit that even if Section 501 be not applied, the Commissioner's method for the determination of "earnings and profits" is nevertheless correct, for it is predicated upon a correct

construction of the Revenue Act of 1938 as originally enacted.

Since the adoption of the Sixteenth Amendment, all of the Revenue Acts have included "dividends" in the gross income of individuals which, less deductions, is subject to tax. All Revenue Acts from that of 1916 (Section 2 (a) thereof) to and including Section 115 (a) of the Internal Revenue Code, have defined the term "dividends" as any distribution made by a corporation, whether in cash or other property, out of its "earnings or profits". In time, Congress provided that no gain or loss should be recognized upon the transfer of property to a corporation by persons in exchange for the corporation's stock where immediately after the exchange the transferors were in control of the corporation, and then to prevent evasions provided that the basis to the corporation for property so acquired should be the same as it would be in the hands of the transferor.

Eventually some taxpayers raised the question whether a corporation's basis for determining its "earnings or profits" upon the sale or other disposition of property for which it had issued its

See, e. g., Section 202 (c) (3), Revenue Act of 1921; Section 203 (b) (4), Revenue Act of 1924; Section 112 (b) (5), Internal Revenue Code.

See, e. g., Section 204 (a) (8), Revenue Acts of 1924 and 1926; Section 113 (a) (8), Internal Revenue Code; Paul, *Studies in Federal Taxation (Third Series)* 3, 30.

stock, was the same as the corporation's basis for determining its gain or loss from the particular sale or disposition of the property. To resolve any possible obscurity on this point, the Treasury Department covered it by regulation. Article 115-1, Treasury Regulations 86, relating to the Revenue Act of 1934, provided:

Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized [for tax purposes] under that section.

The same provision was repeated in subsequent Regulations which implemented like provisions of the subsequent Revenue Acts.⁶ In essence, the rule stated in the Regulations rested upon the view that the provisions of the Acts directing the nonrecognition of gain or loss upon reorganization exchanges were to be read together with the provisions of Section 115 which defined dividends, and this construction is supported by both the language and purpose of the statutory provisions so implemented. Although prior to the enactment of Section 501 there was no statutory provision dealing expressly with the precise point covered by the regulation, the Revenue Acts did contain

⁶ See Article 115-3 of Treasury Regulations 94 (1936 Act) and Treasury Regulations 401 (1938 Act); Section 19.115-3 of Treasury Regulations 103 and Section 29.115-3 of Treasury Regulations 111, promulgated under the Internal Revenue Code.

rather clear indication that gains and losses not recognized for the purpose of computing taxable income should likewise not be recognized for the purpose of computing "earnings and profits", and that, as one consequence thereof, upon the disposition of property acquired in a tax-free exchange "earnings and profits" should be determined by taking the same basis as would be applicable for the determination of taxable gain or loss. Section 111 (c) of the Revenue Act of 1938 (Appendix A, *infra*, p. 48) provided:

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized *for the purposes of this title*, shall be determined under the provisions of section 112. [Italics supplied.]

Since Section 115, which defines dividends, is part of the same title as Section 111, the words "for the purposes of this title", as has been observed,¹⁰

seem to lead inescapably to the conclusion that unrecognized gains are to remain un-

⁹ The language is similar in all of the Acts since that of 1924 in which the basic pattern of the reorganization provisions and their correlative basis provisions was set. See Section 202 (d) of the Revenue Acts of 1924 and 1926; Section 111 (d) of the Revenue Act of 1928; Section 111 (c) of the Revenue Acts of 1932, 1934, 1936, 1938 and of the Internal Revenue Code.

¹⁰ Paul, *Selected Studies in Federal Taxation* (Second Series) 149, 194.

recognized for all income tax purposes, and that the nonrecognition provisions apply as well to the ascertainment of "earnings or profits" as to the computation of taxable net income. [Italics in text.]

It should be observed that the construction placed upon the Acts by the regulation is not a one-way rule operating always in favor of the revenue; in many cases it results in a smaller tax. Thus under the regulation and Section 501, earnings and profits available for dividends are often minimized.¹¹

This construction, moreover, is in accord with the fundamental principle of the nonrecognition provisions that the exchanges therein described should be without tax effect because economically they do not result in changes in substantive interests, but are alterations in form only. It would be inconsistent with this principle to ascribe tax results indirectly to such exchanges by reflecting their effect in the determination of "earnings and profits." This is the underlying theory in the leading case of *Commissioner v. Sansone*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, in which the court stated that the nonrecognition provisions (p. 933) "should be read as a gloss on the provisions defining dividends, and which

¹¹ See the illustrations in the Committee Reports, and Paul, *Studies in Federal Taxation* (Second Series) 149, 185-189; see also pp. 41-42 *infra*.

has been approved by the Congress on several occasions.¹²

The issue does not turn, however, upon a showing that the statutory provisions inevitably required the construction placed upon them by Article 115-1 of Treasury Regulations 86, and the similar provision in the succeeding Regulations.¹³ The regulation should not be held invalid "unless unreasonable or inconsistent with the statute". *Fauces Machine Co. v. United States*, 282 U. S. 375, 378. It is enough that the statutes did not require a contrary construction, for the regulation represents, at the minimum, a permissible construction upon a doubtful point by the officials charged with the duty of administering the law. This should be sufficient to sustain its validity. *Boske v. Comingore*, 177 U. S. 459, 470; *Brewster v. Gage*, 280 U. S. 327, 336; *United States v. Kirby Lumber Co.*, 284 U. S. 1, 3; *Securities Allied Corp. v. Commissioner*, 95 F. 2d 384 (C. C. A. 2d), certiorari denied, 305 U. S. 617.

Moreover, following the promulgation under the Revenue Act of 1934 of the first regulation upon the point, Congress reenacted the statutory provisions without change in the Revenue Acts of 1936 and 1938, and, until the enactment of Sec-

¹² In addition to the approving reference to the *Sansome* case in the House Committee Report relating to Section 501 (Appendix B, *infra*, p. 61), see S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 678, 696).

¹³ See p. 17, *supra*.

tion 501 of the Second Revenue Act of 1940, made no change in this respect in the Internal Revenue Code in any of the Revenue Acts passed after the adoption of the Code in 1939. In this connection it should be noted that in the Revenue Act of 1936, Congress legislated with respect to one aspect of the "earnings and profits" problem by providing expressly (Section 115 (h)) that "earnings and profits" should not be deemed to be diminished by corporate distributions which were not subject to tax in the hands of the shareholders. In view of the importance of accurate rules for computing "earnings and profits" under the Revenue Act of 1936, because of the surtax on undistributed profits which was levied by that Act, the failure of Congress to disapprove the rule stated in Article 115-1 of Treasury Regulations 86 is especially significant. Under the familiar doctrine, the regulation should be deemed to have acquired the force and effect of law. *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459; *Helvering v. Winnell*, 305 U. S. 79, 83; *Helvering v. Griffiths*, 318 U. S. 371, 395, 397.

In addition to the significance attributable to the failure of Congress to disapprove the administrative construction when it enacted the Revenue Act of 1936 and subsequent Revenue Acts, the rule that the regulation should be given the force and effect of law has special applicability here, for it does not depend upon an implication that Congress approved the administrative construc-

tion by failing to disapprove; here the approval was pointedly and expressly voiced by the enactment of Section 501 of the Second Revenue Act of 1940 by which Congress wrote into all of the Revenue Acts the rule stated in the Regulations. Cf. *Morrissey v. Commissioner*, 296 U. S. 344; *Olin Mission Co. v. Helvering*, 293 U. S. 289.

Although the Board of Tax Appeals took a view of the statute contrary to that expressed in the Regulations, and the Board's view has been sustained by the Third and Fifth Circuits, neither it nor those courts (nor the Ninth Circuit in the instant case) has ever considered whether the regulation represents a permissible construction of the statute.

In *F. J. Young Corp. v. Commissioner*, 35 B. T. A. 860, affirmed, 103 F. 2d 137 (C. C. A. 3d), the Board held that an unrecognized gain resulting to a corporation from a tax-free exchange by it of certain assets for stock of the transferee corporation effected an increase in the transferor's earnings and profits available for dividend distribution. In *W. S. Farish & Co. v. Commissioner*, 38 B. T. A. 150, affirmed, 104 F. 2d 833 (C. C. A. 5th), it was held that in determining whether a corporation had been availed of for the purpose of preventing the imposition of surtax upon its shareholders through the unreasonable accumulation of "gains and profits", the corporation could compute its gains and profits on the basis of the market value of assets

which it had acquired in a tax-free exchange rather than upon the transferor's basis.

Although Treasury Regulations 86 had been promulgated prior to the decisions in these cases, both of them involved tax years prior to those covered by those Regulations, and Article 1171 thereof was disposed of in the *Young* case, both by the Board and the Third Circuit Court of Appeals, upon the ground that it was for that reason inapplicable. In the *Farish* case neither the Board nor the Fifth Circuit referred to the regulation. Thereafter, in subsequent cases, the Board has relied upon the authority of its own decisions, and has adhered to its view.¹⁴

¹⁴ *Elmhurst v. Commissioner*, 41 B. T. A. 348; *Faulkland Corp. v. Commissioner*, decided November 8, 1941 (1941 P-H B. T. A. Memorandum Decisions Service, par. 48,197); *Estate of Fisher v. Commissioner*, decided April 26, 1944 (1944 P-H Memorandum Decisions Service, par. 49,132); *Senior Investment Corp. v. Commissioner*, 2 T. C. 121. The *Fisher* and *Senior Investment* cases are now pending on the Commissioner's appeal in the Circuit Court of Appeals for the Sixth Circuit. In the *Elmhurst* case the Commissioner published his nonacquiescence (1941-1 Cum. Bull. 10) and took an appeal but while the case was pending an offer in compromise was accepted and the appeal was dismissed. The *Faulkland* case was likewise appealed by the Government, but while pending the case was rendered moot by the enactment of Section 501 of the Revenue Act of 1942 which by adding Section 26 (f) to the Revenue Act of 1936 entitled the taxpayer to a credit sufficient to expunge the deficiency regardless of the correctness of the grounds upon which the Board had predicated its decision. In consequence, the Board's decision was affirmed upon stipulation of the parties.

The Board's view appears to be based upon the thought that the nonrecognition provisions apply only to the determination of gains or losses for the purpose of computing tax, but not for the purpose of determining the earnings and profits of a corporation available for distribution as a dividend. We think this involves a disregard of Section 111 which directs, as we have pointed out, that the nonrecognition provisions should be applied for all purposes of the income tax title. In any event the question is not whether the regulation adopted the best of all possible constructions of the statute but simply whether it adopted a reasonably permissible construction, and we submit that in no view of the statute can it be said that the regulation is plainly erroneous. In this connection it should be pointed out that the regulation antedated any of the Board's decisions upon the question. Treasury Regulations 86 were approved by the Secretary of the Treasury on September 6, 1934, and the *Young* and *Farish* cases were not decided by the Board of Tax Appeals until 1937 and 1938, respectively. Even if the Board of Tax

The taxpayers have contended that in several cases prior to the *Young* and *Farish* decisions the Board of Tax Appeals had announced similar principles. See the cases collected in note 3 of the opinion below (R. 126). We do not agree that these cases may be so read but, in any event, all of them, except for *Ayer v. Commissioner*, 12 B. T. A. 284, were decided after the promulgation of Treasury Regulations 86. The *Ayer* case was decided in 1928 in favor of the Government and held, following a regulation dealing with the precise

Appeals had announced its view prior to the promulgation of the regulation, that would not have precluded the Treasury, in the exercise of its continuing rule-making power, from promulgating a different interpretation which, if reasonable, would be binding. *Helvering v. Reynolds*, 313 U. S. 428, 430-433.

II

THE BASIS USED BY THE COMMISSIONER FOR THE DETERMINATION OF "EARNINGS AND PROFITS" IS CORRECT UNDER SECTION 501

A. THE SECTION IS APPLICABLE

The taxpayers may renew here the contention which they have urged below that the effective date of Section 501 is ambiguous and that it should therefore be construed to apply only to 1939 and subsequent taxable years. However, as both of the courts below have held, the Section was clearly intended to be fully and completely applicable to the year 1938 as well as to prior years; the terms of the Section and its legislative history permit of no other conclusion.

Subsection (a) amends the Internal Revenue Code and declares the rules for the determination of earnings and profits; subsection (b) provides for the application of subsection (a) to all point, that a distribution out of a depletion reserve based on discovery value was a dividend to the extent that the reserve represented the excess of the discovery value over cost.

taxable years beginning after December 31, 1938; and subsection (c) provides that—

For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment.

The words of the Section are plain and no ambiguity can be distilled from its form. The form in which the Section is cast is one which has frequently been used since the codification of the revenue laws in 1939 into the Internal Revenue Code. With respect to the income tax, all taxable years beginning after December 31, 1938, are governed by the Code and subsequent Revenue Acts have been in the form of amendments to the Code. In general, the amendments made by the later Acts have been made applicable only for the year in which the particular Act was adopted, and for future years. Where it has been intended that a particular provision be applicable for the years between the adoption of the Code and the enactment of the amendment, that has been accomplished by a provision similar to

Section 1.

E. g., Section 2 of the Revenue Act of 1940, Section 101 (c) of the Second Revenue Act of 1940, Section 118 of the Revenue Act of 1941, and Section 101 of the Revenue Acts of 1942 and 1943.

subsection (b) of Section 501,¹⁸ and where it has been intended that a provision be applicable to years prior to those governed by the Code, that has been accomplished by a provision similar to subsection (c) of Section 501,¹⁹ quoted above.

Moreover, the final sentence of subsection (c),²⁰ which provided that the amendment should not affect tax liabilities in cases pending in the Board of Tax Appeals or in a court on September 20, 1940, would be completely without meaning if it

¹⁸ See, *e. g.*, in the 1942 Act, Sections 116 (b), 121 (d), 134 (f), 146 (b) and 186 (f).

¹⁹ See, *e. g.*, in the 1942 Act, Sections 116 (c), 121 (e), 134 (g), 146 (b), 161 (b), 186 (f) and 501 (b).

²⁰ This sentence reads:

Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was heretofore determined by, the Board of Tax Appeals, or any court of the United States.

This exception was introduced in the Senate by the Finance Committee, whose report, as well as that of the Conference Committee (Appendix B, *infra*, pp. 63, 65-66), makes clear that Congress did not intend to direct that rules different from those provided by subsection (a) be applied to cases pending on September 20, 1940. The exception means only that the rules of subsection (a) are not *required* to be applied to pending litigation, and appears to represent no more than a scrupulous avoidance of direct interference by the Congress in the decision of cases then before the courts. Consistently with the view that Section 501 merely represents the proper interpretation of the prior law, T. D. 5024, 1940-2 Cum. Bull. 110, 117, provides that the same rules are applicable to cases pending on September 20, 1940, as are applicable to other cases.

had not been intended by the subsection to affect all tax liabilities for the year 1938 other than in cases pending on that date. It will be observed that the exception appears in, and is limited to, subsection (c) which deals only with the year 1938 and prior years.

Any possible remaining doubt is dispelled by the Committee Reports. The House Report states (Appendix B, *infra*, p. 61): "Section 401 of the bill inserts subsection (1) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts". The Senate Report deals at length with the point and both it and the Conference Report explain the application of the exception made by the last sentence of Section 501 (c) in terms which permit of no meaning other than that, save for cases covered by the exception, the Section provided (p. 63, *infra*) "a uniform rule . . . for all prior taxable years".

It is, of course, true that, in general, an ambiguous statute will be construed to have prospective operation only and that a construction which avoids consideration of a constitutional question will be preferred over one which raises substantial constitutional issues; but these general rules for ascertaining the Congressional intent have no place where, as here, that intent is plain. See *Hopkins Savings Assn. v. Cleary*, 296 U. S. 315, 334, 335.

Courts have striven mightily at times to canalize construction along the path of

safety. *Moore Ice Cream Co. v. Rose*, 289 U. S. 373, 379. When a statute is reasonably susceptible of two interpretations they have preferred the meaning that preserves to the meaning that destroys. *United States v. Delaware & Hudson Co.*, 213 U. S. 366, 407; *Knights Templars' Indemnity Co. v. Jarman*, 187 U. S. 197, 205; cf. *Illinois Central R. Co. v. Public Utilities Comm'n.*, 245 U. S. 493, 510; *Savage v. Jones*, 225 U. S. 501, 533. "But avoidance of a difficulty will not be pressed to the point of disingenuous evasion." *Moore Ice Cream Co. v. Rose*, *supra*. "Here the intention of the Congress is revealed too distinctly to permit us to ignore it because of mere misgivings as to power." *Ibid.* The problem must be faced and answered.

See also *Cooper v. United States*, 280 U. S. 409.

B. THE SECTION IS CONSTITUTIONAL.

1. *The Section merely resolved a doubt which had arisen under the existing law and Congress has power so to act.*

(a) The *Young* and *Farish* cases (*supra*, p. 22), which had been decided by the Board of Tax Appeals in 1937 and 1938, respectively, were affirmed by the Third and Fifth Circuits in 1939. Although these cases involved taxable years prior to those covered by the regulation and therefore did not directly rule upon its validity, they obviously did cast an aura of doubt about the correctness of the administrative interpretation of the statute upon an important and often recurring question. If

was in these circumstances that, in the year following the Circuit Court of Appeals decisions in those cases, Congress, finding that the "need for certainty" made "it desirable to clarify existing law," enacted Section 501 of the Second Revenue Act of 1940, ratifying the rule expressed in the Treasury Regulations. As we have pointed out under point I herein (p. 19, *supra*), the rule thus ratified is not a one-way rule, for its operation may in many cases result in a smaller tax.

The Committee Reports leave no room for doubt that Congress was of the view that, by enacting Section 501, it was doing no more than providing expressly for a rule which had always been intended. Such a declaration of Congressional purpose should be conclusive. *Helvering v. Twin Bell Syndicate*, 293 U. S. 318, 322; cf. *Helvering v. N. Y. Trust Co.*, 292 U. S. 455, 468-469; *Harrison v. Northern Trust Co.*, 317 U. S. 476, 479.

The report of the Committee on Ways and Means states at the outset that the purpose of the provision "is to clarify the law". It then refers with approval to the decision in the *Sansome* case (see p. 19, *supra*) and to the rule "applied by the Treasury under existing law", with the comment that that rule "effectuates the provisions of section 142". After pointing out that—

While taxpayers generally have concurred in the rule applied by the Treasury, the

See H. Rep. No. 2894, Appendix B, *infra*, p. 62.

Board of Tax Appeals and some of the courts have not agreed, but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. * * *

and referring specifically to the *Young* case as an example, the Committee stated that "the need for certainty, * * * makes it desirable to clarify existing law". The first sentence of that portion of the Finance Committee's report dealing with Section 501 states that "The committee amendment rearranges Section 401 of the House bill but otherwise makes no substantial change".

The court below remarked with respect to these clear statements of the Congressional understanding of the legislation as merely clarifying that (R. 127) "this was eliminated before its passage". This comment seems to have resulted from confusion on the part of the court between the drafts of the legislation and the Committee Reports. None of the drafts of what became Section 501 ever contained any statement that its purpose was to clarify the law, and of course one would not expect to find such a statement in the Section itself. The declarations that the purpose of the amendment was to clarify the existing law appeared where they would be expected to be found, in the Committee Reports. And nothing has been found in the course of the whole legislative history of this provision to indicate that anyone in the Congress thought, at

any stage, that the intent and understanding ~~were~~ other than that expressed in the Committee Reports.

There is thus presented a situation in which the year following two judicial decisions which cast doubt upon the validity of a consistent administrative construction upon a narrow but important point of tax administration, Congress approved and confirmed the administrative understanding of the law, thus effecting a clear, precise, and speedy solution of a troublesome question. We submit that legislative action in such circumstances is not only not unconstitutional, but is salutary. We do not believe that there can be read into the Fifth Amendment any prohibition against such a practice: it is one which should be encouraged, not discouraged, for it affords a method of materially lessening the interim of uncertainty and confusion which attends the necessity of awaiting a final and authoritative judicial decision, with resulting benefits to the administrators of the law, to those subject to the law, and to the courts.

Speedy solution is not the only advantage lying with this legislative method. The clarification of complex provisions of the tax statutes by means of judicial decisions is an "inevitably empiric process". Rarely can a single decision settle more than a comparatively narrow portion of a

problem which may, and usually does, have many ramifications. Congress, however, may paint with a broader brush. The legislative process is not limited to the confines of a single controversy, either in acquiring the information upon which to reach a decision or in providing a solution.

Finally, the practical effect of a denial of Congressional power here would be to require every disputed question of the interpretation of the revenue laws to be brought to this Court for settlement, for it would rule out the only alternative, that of going to Congress for a clarifying amendment applicable to prior years.

(b) It is urged by the taxpayers, and the court below has held, that Congress was without power so to act. The essence of the taxpayers' position is that, even if (as the enactment and legislative history of Section 501 show) the Board's decisions in the *Young* and *Fairish* cases were erroneous, they somehow acquired a vested right in those decisions, a right so complete as to be entitled to constitutional protection. Cf. *Dunbar v. City of New York*, 251 U. S. 516, 518-519; *United States v. Heinszen & Co.*, 206 U. S. 370, 386-388. The contention takes the form of an assertion that at the time of the dissolution of the Wheeler Company on December 2, 1938, the "law" sanctioned the method which the taxpayers urge for computing "earnings and profits," and the inference is sought to be created that they relied upon that "law" in liquidating the company. From these

premises the conclusion is urged that application here of a different rule is "unfair" and that such "unfairness" is unconstitutional.

We submit, however, that neither premise of the argument is well founded. There is no basis for the taxpayers' view as to what the "law" was on December 2, 1938, and there is likewise no basis for their assertion that they did in fact rely upon that "law". Furthermore, even if it should be assumed that both of these premises are valid, there is nevertheless no constitutional objection to the application here of Section 501.

1. The Board of Tax Appeals decided the *Young* case in 1937 and the *Farish* case in 1938. The Commissioner announced his nonacquiescence in the *Young* case, and took an appeal in it and in the *Farish* case, and the affirmances of these decisions by the Third and Fifth Circuits did not come until 1939. Thus the "law" on December 2, 1938, consisted of the Revenue Act of 1938 (which contained no provision expressly dealing with the precise question of the proper method of computing earnings and profits upon the disposition by a corporation of properties acquired in a tax-free exchange), the Treasury Regulations (which expressly announced a rule contrary to the taxpayers' view and which neither the Board of Tax Appeals nor any court had held invalid).

¹ 1937-2 Cum. Bull. 56.

At the time of the dissolution of the Wheeler Company neither the Board of Tax Appeals nor any court had held

and the decisions of the Board of Tax Appeals in the *Young* and *Farish* cases (decisions with respect to which the Commissioner had announced his disagreement and which he was then challenging in the Circuit Courts of Appeals). The taxpayers have, argued, and the Circuit Court of Appeals seems to have thought (see footnote 3 of the opinion, R. 126), that several decisions of the Board of Tax Appeals prior to the *Young* case had also announced the rule for which they contend. We do not agree that these decisions stand for the proposition for which they have been urged (see note 15, p. 24, *supra*), but it does not appear necessary to discuss them at length. Not only did none of them deal with or involve the regulation, but for present purposes the decisive consideration is that at the time of the dissolution of the Wheeler Company there was not only no final decision upon the point, but there was ample notice that the Government was of the view that the Board's position was erroneous. This notice was given by the announced nonacquiescence in the *Young* case, by the prosecution of appeals from the adverse

the regulation invalid. Nor even since that time has any appellate court, except for the decision in the instant case, held the regulation invalid. That issue is now pending in the Sixth Circuit in *Estate of Fisher v. Commissioner*, decided by the Tax Court on February 9, 1944 (1944 P-H T. C. Memorandum Decisions Service, par. 44,034), a case arising under the last sentence of Section 501 (c) which excepted from operation of the Section cases in litigation on September 20, 1940. See p. 27, *supra*.

Board decisions, and by the adherence to and repromulgation of the regulation.²⁵

Although the attention of the Circuit Court of Appeals was directed to these facts which show the unsettled state of the law at the time of the dissolution of the Wheeler Company, the court responded by characterizing the point as a "hoax" that the Commissioner "had flouted the court [Board of Tax Appeals]" (R. 126). The Commissioner's practice of announcing acquiescence or nonacquiescence in Board decisions is not, however, thus to be condemned, for it is a desirable practice dating from the inception of the Board of Tax Appeals. It indicates the course of "official opinion in the administration of the Bureau of Internal Revenue" which furnishes a guide not only for the personnel of the Bureau, but to taxpayers and their counsel. There is no express provision in the statutes requiring the Commissioner to announce such acquiescence or nonacquiescence, but the practice has been deemed so desirable that when, in 1926, the Board was established in its present form, representatives of taxpayers urged Congress to make it mandatory. Such a require-

Thus Treasury Regulations 101 were promulgated on July 19, 1938 (p. 741) while the *Young* case was pending on appeal, and Treasury Regulations 103 were promulgated on August 25, 1939, after the Circuit Courts of Appeals had decided both the *Young* and *Farish* cases.

²⁵ See the notice appearing on the front cover sheet of each issue of the Internal Revenue Bulletin. Cf. *Helvering v. A. F. Frost Co.*, 292 U. S. 455, 468.

ment was not incorporated into the law only, it seems, because it was unnecessary, since the Commissioner was already following the practice.²⁷

These are considerations of weighty significance in considering the charge of unconstitutionality, which is here leveled at Section 501. No one could have justifiably assumed on December 2, 1938, that the Board's view as expressed in the *Young* and *Farish* cases was correct. Cf. *Higgins v. Smith*, 308 U. S. 473, 478-479. Those cases were themselves then pending on appeal and there was certainly a possibility that they would be reversed by the Circuit Courts of Appeals in which they were pending. Even if, as later developed, those courts did affirm the decisions, there was the additional possibility that the Government's view would ultimately be sustained by this Court, either in the *Young* and *Farish* cases or in some other case, such as this one. Thus, even if it should be assumed that the taxpayers knew, or were advised, of the state of the law upon this point concerning reorganizations under the tax statutes, and if in that situation they determined to liquidate the Wheeler Company in reliance upon the Board's decisions, they did no more than elect to challenge the Government on its position, knowing that there was at least the possibility that the Government would ultimately be sustained.

²⁷ See Revenue Revision 1925, Hearings before the Committee on Ways and Means, 69th Cong., 1st Sess., pp. 849, 878, 926-7, 931, 933, 937.

2. Not only was there no basis upon which anyone could justifiably have relied on December 2, 1938, upon the Board's decisions as establishing the "law" with respect to the method of computing "earnings and profits" upon the disposition by a corporation of assets acquired in a tax-free exchange, but there is no evidence in the Record, and the Tax Court expressly refused to find, that the taxpayers herein did in fact so rely.

It is stipulated that the dissolution occurred after consideration was given (R. 34) "to the application of Section 112 (b) (7) of the Revenue Act of 1938". That Section provided that upon the liquidation of a corporation pursuant to its provisions, the shareholders should be taxed on that portion of their resulting gain which represented the corporation's "earnings and profits", but it said nothing about how "earnings and profits" should be computed. The stipulation does not state, nor is there anything in the Record to show, that the taxpayers took into account or relied upon the Board's then view as to how "earnings and profits" should be computed in a situation such as is here involved. We do not believe that the Record would support a finding in accordance with the taxpayers' assertion as to their reliance, but it may be assumed *arguendo* that the Tax Court might properly have drawn the inference, and therefore might properly have made a finding, that the taxpayers did in fact rely upon those early decisions and would not otherwise have

liquidated the corporation. However, the Tax Court did not draw that inference and did not make such a finding; instead, it expressly refused to do so.

The Tax Court pointed out that Congress, having found that the use of personal holding companies was "the most prevalent form of tax avoidance practiced by individuals with large incomes",²⁸ had from the Revenue Act of 1934 to that of 1938 imposed progressively heavier taxes upon such corporations, until by 1938 there was, in many instances, no longer any tax benefit in the use of personal holding companies but they had come in fact to be tax burdens; that therefore quite aside from the opportunity afforded by Section 112 (b) (7) there was strong motivation in 1938 to be rid of personal holding companies (R. 73-74); and that even with the tax computed under the Commissioner's method of determining "earnings and profits" the taxpayers paid a substantially lower tax as the result of the application of Section 112 (b) (7) than they would have paid had the Wheeler Company been liquidated without electing to come under that Section (R. 78-79). The Tax Court consequently characterized as (R. 74) "without substance" the taxpayers' contention that they would not have liquidated the corporation had they not expected the tax to be

²⁸ H. Rep. No. 704, 73rd Cong., 2d Sess., p. 11 (1939-40 Cum. Bull. (Part 2) 554, 562).

computed in accordance with their method of determining "earnings and profits".

These portions of the Tax Court's opinion deserve attention in view of the language in which its opinion was criticized by the Circuit Court of Appeals. The Tax Court did not make any affirmative finding that the Wheeler Company was formed for purposes of tax avoidance, or that its dissolution was motivated by such considerations, nor did it make any affirmative finding that the Wheeler Company would have been liquidated in 1938 even if the benefits of Section 112 (b) (7) had not been available. The Tax Court simply stated its reasons (a) for concluding that application of Section 501 did not lead to any harsh result, and (b) for declining to draw the inference or to make the finding pressed by the taxpayers that they did in fact rely upon the early Board decisions and would not otherwise have liquidated the corporation. The Tax Court's discussion was germane to the issues argued by the taxpayers. The Circuit Court of Appeals, however, charged the Tax Court with making findings which were unsupported by the Record; characterized its discussion as (R. 125) "betray[ing] an animus against" the taxpayers "because they were stockholders" in "a personal holding company"; and censured the Tax Court with the statements that it was "prejudice[d]" and had not adopted an "impartial approach to the issues". As we have

undertaken to show, analysis of the Tax Court's opinion reveals that these serious charges are without foundation.

The views of the Circuit Court of Appeals seem to have followed, at least in part, from a misunderstanding of the effect of Section 112 (b) (7), and of the application to that Section of the rule stated in the regulation, which Section 501 confirmed, for the determination of earnings and profits. The court pointed out (R. 125) that Section 112 (b) (7) "was enacted for the purpose of encouraging and facilitating prompt liquidation of personal holding companies," and added that under the Commissioner's method of computing earnings and profits there would not have been "such or any encouragement". But we feel that the court was in error in its conclusion, both with respect to the general effect upon Section 112 (b) (7) of the Commissioner's method of computing earnings and profits and with respect to its application in this case. As we have pointed out (*supra*, pp. 19, 30), the rule confirmed by Section 501 does not always result in a larger tax. With respect to companies which, like the Wheeler Company, had acquired assets in tax-free exchanges for their own stock and were contemplating liquidation pursuant to Section 112 (b) (7), the tax would be less under the rule applied by the Commissioner than under the rule which the taxpayers here urge, if the assets acquired

had been worth less at the time of acquisition than their cost to the transferors, and had thereafter appreciated in value by the time of their subsequent sale by the corporation. And, as the Tax Court pointed out (R. 78-80), with respect to its effect in the instant case, even under the Commissioner's application of Section 412 (b) (7) there was ample encouragement for the liquidation of the Wheeler Company, since the tax was much less than would have been due if the liquidation had been effected without the benefits of that section.

Even if the Section be treated as effecting a clear and sharp change in the prior law, it is nevertheless not unconstitutional.

Assuming, *arguendo*, that the taxpayers' contentions with respect to the state of the law on December 2, 1938, and their alleged reliance

in the case of John H. Wheeler, for example, the liquidation resulted in a gain under Section 115 (c) of the 1938 Act, of at least \$158,830.91, since the basis for his stock did not exceed \$153,505.01, and he received in exchange therefor property worth \$312,335.92 (R. 63; cf. R. 78). Under Section 417 (b) \$79,415.46 (50 percent of the gain) would have been taxable in 1938. Under the Commissioner's application of Section 412 (b) (7) the total gain subject to tax was only \$66,899.55 (consisting of a dividend out of "earnings and profits" in the amount of \$66,406.69, and 50 percent (\$402.86) of the total of cash and post-September 9, 1938 securities received in the liquidation). (See Statement, *supra*, p. 6.) In addition, the amount taxable as a dividend was reduced by \$2,976.53 as a result of the Tax Court's modification of the Commissioner's computation of "earnings and profits" by the item of \$5,973.06 (see Statement, *supra*, p. 8).

thereon, are valid, there would nevertheless be no constitutional objection to the application of Section 501.³⁰ Retroactivity does not spell unconstitutionality. Retroactivity in varying degrees has been a feature of every federal income tax since those first enacted during the Civil War days, but they have been uniformly held unobjectionable on that account whenever the point has been raised.³¹ Indeed, the decision of the Circuit Court of Appeals herein appears to be the first by any court which has held a federal income tax provision violative of the due process clause. Cf. *Hudson v. United States*, 12 F. Supp. 620, 13 F. Supp. 640 (C. Cls.), reversed, 299 U. S. 498.

Carliss v. Bowers, 281 U. S. 376; *Reinecke v. Smith*, 239 U. S. 172, and *Buruel v. Wells*, 289 U. S. 670, involved provisions taxing the income of certain trusts to the settlor and sustained their application to trusts created when there was no such provision in the law. *Cooper v. United States*, 280 U. S. 409, sustained the application of a provision of the Revenue Act of 1921 fixing a new basis for property acquired by gift, in a case in which the property had been acquired in 1916 and had been sold prior to the enactment of the statute. Such retroactive changes in the basis provisions, especially with respect to property transferred pursuant to reorganizations, have

³⁰ See the dissenting opinion by Mr. Justice Brandeis in *Untermeyer v. Anderson*, 276 U. S. 440, 446-449.

been commonplace³¹ and have been sustained whenever challenged.³²

Truly retroactive legislation has recently been considered in *Wilgard Realty Co. v. Commissioner*, 127 F. 2d 514 (C. C. A. 2d), certiorari denied, 317 U. S. 655; see also *Commissioner v. Corpus Christi T. Co.*, 126 F. 2d 898 (C. C. A. 5th); *D. W. Klein Co. v. Commissioner*, 123 F. 2d 871 (C. C. A. 7th), certiorari denied, 315 U. S. 819. These cases involved Section 213 (f) of the Revenue Act of 1939, which was enacted as a legislative reversal of the principles declared in *United States v. Hendler*, 303 U. S. 564, and was made effective with respect to each Revenue Act since that of 1924. The *Wilgard* and *Klein* cases applied the Section to transactions occurring in 1932 and the *Corpus Christi* case to one which had occurred in 1931; in all three the taxpayers were unsuccessful.

³¹See, for example, Section 204 (a) (7) and (8) of the Revenue Act of 1924; Sections 702-706 of the Revenue Act of 1928; Section 113 (a) (7) of the Revenue Act of 1932; Section 113 (a) (5) of the Revenue Act of 1934; Section 113 (a) (7) of the Revenue Act of 1936; Section 115 (h) of the Revenue Act of 1938; Sections 142 and 143 of the Revenue Act of 1942, and Sections 121 and 122 of the Revenue Act of 1943.

³²*Newman, Saunders & Co. v. United States*, 36 F. 2d 1009 (C. Cls.), certiorari denied, 281 U. S. 760; *Osborn California Corp. v. Welch*, 39 F. 2d 41 (C. C. A. 9th), certiorari denied, 282 U. S. 850; *Signal-Gasoline Corp. v. Commissioner*, 25 B. T. A. 861, reversed on other grounds, 66 F. 2d 886 (C. C. A. 9th). See also *Fesler v. Commissioner*, 38 F. 2d 155 (C. C. A. 7th), certiorari denied, 281 U. S. 755; *Phipps v. Bowers*, 49 F. 2d 996 (C. C. A. 2d); *Jackson v. Price*, 74 F. 2d 707 (C. C. A. 2d).

In only three cases has this Court held the retroactive application of any federal tax to be in violation of the Fifth Amendment. *Nichols v. Coolidge*, 274 U. S. 531; *Blodgett v. Holden*, 275 U. S. 142; *Untermeyer v. Anderson*, 276 U. S. 440. These cases involved the application of gift and estate taxes to completed transfers made at a time when no such taxes were in existence. They were narrowly restricted by *Milliken v. United States*, 283 U. S. 15, which held that a gift made in contemplation of death could be subjected to estate tax at rates higher than those prevailing at the time the gift was made. In *Welch v. Henry*, 305 U. S. 134, the Court pointed out, in sustaining a retroactive income tax (p. 148), that these cases are not applicable to income taxes, but in any event the instant case is closer to the *Milliken* case than to the earlier decisions. Section 501 did not impose a new tax; assuming that the Section represents an actual change in the law, its effect here is merely to lessen the tax advantage allowed by Section 412 (b) (7) of the 1938 Act.

A review of the decisions led a commentator to state some ten years ago that—

“Arbitrary retroactivity” may continue hopefully to rear its head in tax briefs, but for practical purposes, in this field, it is as dead as wager of law.”

³³ Ballard, *Retroactive Federal Taxation*, 48 Harv. L. Rev. 592 (1935).

and, except for the decision here under review, the argument has not since been revitalized.

The court below has read *Welch v. Henry*, 305 U. S. 134, as standing for the flat rule that an income tax provision cannot be applied retroactively to a year prior to that succeeding the year of the last previous general session of Congress. We do not believe that that decision can be so construed; it does not fix any general limit as to the permissible retroactivity of income tax statutes. The court there sustained a Wisconsin statute enacted in 1935 which imposed a new tax on dividends received in 1933. The Act had been passed by the legislature at its first session after 1933 and that fact was noted in the opinion, but there was no statement or even intimation that an income tax law passed at a subsequent session would on that account be invalid. It should be observed that the Wisconsin statute "was retroactive legislation in the strict sense for it imposed a new tax upon income received two years earlier, and even the dissenting opinion in that case seems to agree that there would be no question of the validity (p. 158) of 'a remedial measure to confirm or ratify a doubtful administrative interpretation of prior legislation'. Cf. *Graham & Foster v. Goodcell*, 282 U. S. 409, 426-430.

¹ It may be noted that the restraints imposed by the Fifth Amendment upon Congress are not as broad as those imposed upon the states by the Fourteenth Amendment. *Steward Machine Co. v. Delis*, 301 U. S. 548, 581.

Under the most extreme view of the effect of Section 501, it constitutes only a revision of an existing system of taxation and the case is well within even the narrowest limitations which have at any time been applied upon the Congressional power.

CONCLUSION

For the foregoing reasons, the judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted.

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JANUARY 1945:

APPENDIX A

Revenue Act of 1938, c. 289, 52 Stat. 447:

TITLE I—INCOME TAX

SUBTITLE C—SUPPLEMENTAL PROVISIONS

SUPPLEMENT B—COMPUTATION OF NET INCOME

SEC. 111. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or ex-

change of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(7) *Election as to Recognition of Gain in Certain Corporate Liquidations.*—

(A) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before or after January 1, 1938; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December, 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at

the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subparagraphs (E) and (F).

(B) *Excluded Corporation*.—The term "excluded corporation" means a corporation which at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 per centum or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(C) *Qualified Electing Shareholders*.—The term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D), but—

(i) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 per centum of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation;

(D) *Making and Filing of Elections*.—The written elections referred to in subparagraph (C) must be made and filed in

such manner as to be not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary. The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) *Noncorporate Shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938; and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(8) *Property Acquired by Issuance of Stock or as Paid-in Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(18) *Property Received in Certain Corporate Liquidations.*—If the property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock with respect to which gain was realized, but with respect to which, as the result of an election made by him under paragraph (7) of section 112 (b), the extent to which gain was recognized was determined under such paragraph, then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by him, and increased in the amount of gain recognized to him.

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term

"dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 113, but shall be recognized only to the

extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of the section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

Second Revenue Act of 1940, c. 757, 54 Stat. 974.

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—
Section 115 of the Internal Revenue Code

is amended by inserting at the end thereof the following new subsections:

“(1) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

“(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

“(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in

determining the increase or decrease above provided.

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

(26 U. S. C. Supp. 111, Sec. 115.)

Treasury Regulations 301, promulgated, under the Revenue Act of 1938:

ART. 112 (b) (7)-1. *Corporate liquidations in December, 1938.*—(a) *General.*—Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within the month of December, 1938, for the treatment of gain on the shares of stock owned by qualified electing shareholders on the date of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation, which would otherwise be

recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and article 112 (b) (7)-2. For the basis of property received on such liquidations see section 113 (a) (18).

(b) *Type of liquidation.* The liquidation must be in pursuance of a plan of liquidation adopted after May 28, 1938. * * *

If a transaction constitutes a distribution in complete liquidation within the meaning of the Act and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

ART. 112 (b) (7)-4. *Treatment of gain—*

(a) *Computation of gain.*—As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 115 (c), and gain from the receipt of such amounts is determined as provided in section 111. * * *

(b) *Recognition of gain.* Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following—

(1) Such share's ratable share of the earnings and profits of the corporation ac-

accumulated after February 28, 1913, computed as of December 31, 1938, without diminution by reason of distributions made during the month of December, 1938; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after April 9, 1938. * * *

(c) *Treatment of recognized gain.*—In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned on the date of the adoption of the plan of liquidation which is not in excess of its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section 112 (b) (7) (E) (i) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated and taxed to him as a short-term or long-term capital gain, as the case may be. * * *

ART. 115-2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. * * *

ART. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or ac-

cumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.¹ Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * *

ART. 115-5. *Distributions in liquidation*.—(a) *General*.—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in ex-

¹ This sentence appears in the regulations promulgated under preceding Revenue Acts: Article 115-3, Treasury Regulations 94 (1936 Act); Article 115-1, Treasury Regulations 86 (1934 Act). The same sentence appears in the Treasury Regulations promulgated under the Internal Revenue Code: Sec. 19.115-3, Treasury Regulations 103 and Sec. 29.115-3, Treasury Regulations 111. See, also, Sections 19.115-12 and 29.115-12 of the same Regulations.

change for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

◇ * * * *

APPENDIX B

COMMITTEE REPORTS

THE SECOND REVENUE BILL OF 1940

H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41:
(1940-2 Cum. Bull. 496, 526-527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (1) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner v. Sansome* (60 Fed. (2d) 931) and following decisions, the rule effec-

tuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was \$100. The fair market value of the stock in the Y Corporation received by the X Corporation was \$1,000. On April 9, 1930, the X Corporation declared a cash dividend of \$900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, \$900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner v. F. J. Young Corporation*, 103 Fed. (2d), 137). Under the proposed legislation and Treasury practice, the \$900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

* * * *

It should be noted that the provisions of section 401 are applicable only in determining the earnings or profits for periods beginning after February 28, 1913. * * *

H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 61-62:

The House bill and Senate amendment provided that, in order to effect a uniform rule for all prior years, the stated rules are made applicable to prior acts, but the Senate amendment added a provision providing that such rules should not affect the tax liability of any taxpayer for any year now pending before, or heretofore determined by, the Board of Tax Appeals, or any court of the United States. The tax liability may be that of the corporation the earnings or profits of which are being determined, or the tax liability of a shareholder of such corporation, or of some other taxpayer. These tax liabilities are left to be determined according to such decisions as the Board or courts may make under existing law. As to all matters except such tax liabilities, such stated rules are applicable, and res judicata will not be applicable. The House recedes with an amendment providing that the exception added by the Senate amendment relative to pending or decided cases shall apply only if the tax liability in question was pending before the Board of Tax Appeals or any court of the United States on September 20, 1940, or was determined prior to such date by the Board of Tax Appeals or any court of the United States.

S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 22, 26 (1940-2 *Chm. Bull.* 528, 545-548):

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS.

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. * * *

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code.

* * * For example, on January 1, 1939, the X Corporation owned stock in the Y Corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was \$100. The fair market value of the stock in the Y Corporation when received by the X Corporation was \$1,000. On April 9, 1939, the X Corporation declared a cash dividend of \$900 and, except for the possible effect of the transaction in 1938, had no accumulated earnings or profits. The excess of the fair market value of the stock of the Y Corporation over the basis, \$900, was not recognized gain under the provisions of section 112

of the Revenue Act of 1938. Accordingly, its earnings and profits are not increased by \$900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of \$28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was \$247,000; and that the corporation, after three years' operations, effected in 1927 a cash distribution to X in the amount of \$165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of \$28,000 established in the non-taxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

The amendments to the Internal Revenue Code made by section 501 (a) are by section 501 (c) made applicable to all prior Revenue Acts, effective as if they were a part of such Act on the date of its enactment, thus effecting the application of a uniform rule for the determination of the earnings and profits of all corporations for all prior taxable years. The last sentence of the subsection provides that only the actual tax liability of a shareholder-taxpayer for a particular year which is now pending

before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall remain unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination the provision of section 501 govern. Section 501 will therefore control for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

* * * * *



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No. 354

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

ERBERT H. WHEELER, ET AL., EXECUTORS OF THE
ESTATE OF JOHN H. WHEELER, DECEASED, ET AL.

ON WRIT OF HABEAS CORPUS TO THE UNITED STATES CIRCUIT
COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM IN OPPOSITION TO PETITION
FOR REHEARING

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MEMORANDUM IN OPPOSITION TO PETITION FOR REHEARING

1. The Court's opinion in this case holds, *inter alia* (p. 3), that Article 115-3 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, "is reasonable and a valid exercise of the rule-making power" and that under that regulation the Wheeler Company was required to compute its earnings and profits resulting from the sale of securities which it had acquired in tax-free exchanges, upon the basis of the transferors' cost of those securities. The opinion pointed out that the regulation represented the administrative interpretation of the law in which the Commis-

sioner had persisted despite adverse decisions on the point by the Board of Tax Appeals and certain lower courts, and noted that before the question was finally judicially considered Congress had clarified the point "by enacting the substance of the regulation" in Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974.

Part one of the respondents' petition for rehearing is predicated upon the suggestions (a) that the regulation has a different meaning from that attributed to it by the Court, and (b) that the Commissioner had taken positions inconsistent with the regulation prior to the enactment of Section 501. We point out that these issues were developed *in extenso* in the respondents' original brief herein (pp. 16, 25, 28-30, 30-34, 62-65), and the Court will recall that a substantial portion of the oral argument was devoted to them. In any event, respondents' position upon these points is untenable.

(a) Article 115-3 provides that—

Gains and losses within the purview of section 412 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

¹ It will be observed that the regulation applies to "gains and losses within the purview of section 412 or corresponding provisions of prior Acts." Cf. petition for rehearing, pp. 29-30.

When the Wheeler Company sold the securities involved in this case, "the extent" to which a gain resulted under Section 112 was the difference between the price which it received for those securities and the cost of them to the company's transferors. That was "the time" and "the extent" that the gain to the corporation was recognized; and under the regulation it is to that extent that the gain was required to be reflected in the corporation's "earnings and profits."

It is not true that the Tax Court has ever announced, much less "persisted in" or "established" (cf. petition for rehearing, pp. 5-9), a construction of the regulation contrary to that made by this Court. The fact is that the Tax Court has never construed the regulation; nor has it ever expressly decided whether the regulation represented a permissible interpretation of the statute by the Treasury, to which has been committed the rule-making power under the revenue laws. As our brief pointed out (pp. 22-25), although the promulgation of the regulation antedated the first decisions by the Board of Tax Appeals upon the problem, those cases involved tax years prior to those governed by the regulation, and the Board therefore did not consider either its meaning or its validity. In those cases the Board construed the statute in a manner different from that provided by the regulation; thereafter, in subsequent cases the Board adhered

to its views, not, however, upon the basis that the regulation was not intended by the Commissioner to apply to cases of the instant type, but upon the authority of its own prior decisions.

The petition for rehearing repeats the respondents' contention that the regulation applies only to one facet of a tax-free exchange. It is said that the regulation applies where a corporation transfers, in a tax-free exchange for the stock of another corporation, assets which have appreciated in value; that in such a case the effect of the regulation is to provide that the unrecognized gain resulting to the transferor corporation should not at that point affect its earnings and profits available for dividend distribution; *F. J. Young Corp. v. Commissioner*, 35 B. T. A. 860, affirmed, 103 F. 2d 137 (C. C. A. 3d), is referred to as illustrative of the problem with which the regulation is concerned. It is further suggested that the question as to the proper basis to be used by the transferee corporation for the purpose of determining its earnings and profits upon subsequent disposition of such assets, is an entirely unrelated question and is one, furthermore, which is not dealt with either by the regulation or by Section 501.

The regulation does, of course, deal with cases of the *Young* type. Respondents' further suggestion, however, that cases of the instant type present a wholly different problem and that the

regulation deals only with the *Young* type of question, is not correct. The contention is refuted not only by the plain language of the regulation, but by the Tax Court's treatment of these issues, by the treatment accorded them by Congress when it came to enact Section 501, and by the administrative treatment thereafter.

The Tax Court has treated cases of the *Young* type and cases of the instant type as involving but facets of a single problem. It has never suggested that any different considerations were involved in the one aspect of the problem from those involved in the other. Quite to the contrary, it has cited the *Young* case as supporting its decisions in cases of the *Wheeler* type. Thus, in *Klinckschmidt v. Commissioner*, 41 B. T. A. 348, 354 (a case of the instant type), it said:

Since *W. S. Farish & Co.* has been affirmed, 104 Fed. (2d) 833, by the Circuit Court of Appeals for the Fifth Circuit, and since the same conclusion, in effect, in *F. J. Young Corporation*, 35 B. T. A. 869, has been affirmed by the Circuit Court of Appeals for the Third Circuit, 103 Fed. (2d) 137, further discussion of this point is unnecessary, and we hold, in accordance with said cases, that the proper basis is the basis of cost to the corporation.

See also *Falkland Corp. v. Commissioner*, decided November 8, 1941 (1941 P-H B. T. A. Memorandum Decisions, par. 41, 497).

And Congress treated the questions together when it enacted Section 501. The first sentence of the Section dealt with the *Wheeler* aspect of the problem, and the second sentence dealt with the *Young* aspect.

Finally, in the regulations promulgated under Section 501 (T. D. 5024, 1940-2 Cum. Bull. 110), both aspects of the question are dealt with in a single example (example 1, p. 113) illustrating the application of the Section.

(b) The charge that the Commissioner at times took a position inconsistent with the regulation is based upon cases which all involved tax years prior to those first covered by the regulation. Thus, *W. & K. Holding Corp. v. Commissioner*, 38 B. T. A. 830, is cited as a case of the instant type, and *Freshman v. Commissioner*, 33 B. T. A. 394; *McCormick v. Commissioner*, 33 B. T. A. 1046, and *Lea v. Commissioner*, 35 B. T. A. 243,² are cited as cases of the *Young* type in which the Commissioner's position was contrary to that of the regulation. However, the regulation was first promulgated under the Revenue Act of 1934, and the *McCormick* case involved the year 1925, the *Freshman* and *Lea* cases the year 1929, and the *W. & K. Holding Corp.* case the year 1933. No case has been cited, and we know of none, involving a year subsequent to the time when the Treasury's view became crystallized and embodied in

² Reversed, 96 F. 2 155 (C. C. A. 2d).

the regulation, in which there has been any inconsistency.

Moreover, we do not agree that the cases cited by the respondents show any inconsistency even prior to the time of the promulgation of the regulation, but it seems unnecessary to undertake here an analysis of them to show that they are not in point. We note, however, respondents' statement (petition for rehearing, p. 7) that in the *W. & K. Holding Corp.* case "The Commissioner argued exactly the opposite of what he is arguing here." In view of that statement, we have examined the briefs which were filed in that case. Although in that case the Board suggested *obiter* (38 B. T. A. at pp. 840-841), that upon the disposition by a corporation of an asset acquired in a tax-free exchange, the corporation would not use the same basis for the determination of its earnings and profits as would be applicable for the determination of taxable gain or loss, the suggestion appears to have been wholly gratuitous on the part of the Board, for none of the briefs contained any discussion of that question and none of them cited any of the cases to which the Board referred in its dictum.

2. There is no issue here with respect to the continuing authority of *Dobson v. Commissioner*, 320 U. S. 489. If there had been no regulation

³ While in *Elmhirst v. Commissioner*, 41 B. T. A. 348, the regulation was not cited, the Commissioner's position was in accord with it.

upon the point, or perhaps even if there had been an open question concerning the meaning of the regulation and the Tax Court had construed it contrary to the Commissioner's position, the Tax Court's early view, as to the proper basis for computing corporate earnings and profits in a case such as the instant one, might have been thought to be entitled to finality under the *Dobson* case. That, however, is not the situation. The Tax Court had not construed the regulation, but had simply refused to follow it, adopting a position tantamount to a holding that it was invalid, and as the *Dobson* case expressly noted (320 U. S. at p. 502) a question of the validity of a regulation is clearly one of law.⁴

3. With respect to the final point made in the petition for rehearing (pp. 30-31), it seems sufficient to observe that the regulations⁵ have long provided that tax-exempt income is included in a corporation's earnings and profits, and (Paul,

⁴ The point was so treated by the Sixth Circuit in *Commissioner v. Fisher*, decided March 26, 1945 (1945 C. C. H., par. 9239). It held the regulation invalid and upon that premise applied the *Dobson* case to reach the conclusion that the view announced by the Tax Court in its early decisions was entitled to finality. A petition for rehearing has been filed and is pending in the *Fisher* case.

⁵ See Article 1541 of Treasury Regulations 45, 62 and 65; Article 621 of Treasury Regulations 74 and 77; Article 115-1 of Treasury Regulations 86; Article 115-3 of Treasury Regulations 94 and 101; Section 19.115-3 of Treasury Regulations 103; and Section 29.115-3 of Treasury Regulations 111.

Selected Studies in Federal Taxation (Second Series) 149, 162):

It is well settled that dividends, to the extent not embraced in corporate net income, are to be added thereto in computing "earnings or profits."

CONCLUSION

The questions raised by the petition for rehearing were fully presented to the Court and are without merit. The petition should therefore be denied.

Respectfully submitted.

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MAY 1945.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1944

No. 354

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
against

ELLIOTT H. WHEELER and ROLLO C. WHEELER,
EXECUTORS OF THE ESTATE OF JOHN H.
WHEELER, DECEASED, *et al.*,
Respondents.

ON WRIT OF CERTIORARI
TO THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR RESPONDENTS

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

against

ELLIOTT H. WHEELER and ROLLO C. WHEELER,
EXECUTORS OF THE ESTATE OF JOHN H.
WHEELER; DECEASED, *et al.,*

Respondents.

No. 354

ON WRIT OF CERTIORARI
TO THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR RESPONDENTS

OPINIONS BELOW

The opinion of Judge Arnold of the Tax Court is reported at 1 T. C. 640 (R. 57-81). The opinion of Judge Garrecht for the Circuit Court of Appeals of the Ninth Circuit, reversing the Tax Court, is reported at 143 F. (2d) 162 (R. 121-130).

JURISDICTION

The jurisdiction of this Court is invoked under § 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (43 Stat. 938, 28 U. S. C. § 347(a)). The judg-

ment of the Circuit Code of Appeals was entered on May 16, 1944 (R. 130), the several cases having been consolidated for purposes of review in that Court by its order dated August 24, 1943 (R. 114). Petition for writ of certiorari was filed on August 16, 1944, and was granted on October 16, 1944 (R. 131).

QUESTIONS PRESENTED

1. The ultimate question in this case is the following: When a corporation sells property at less than such property cost it, does it have "earnings and profits" from such sale in the sense in which that term is used in the Federal revenue laws,

(a) under the Revenue Act of 1938,

(b) under § 501 of the Second Revenue Act of 1940?

2. Is § 501 of the Second Revenue Act of 1940 in terms or intent retroactive for the purpose of affecting income tax liability for 1938?

3. If § 501 of the Second Revenue Act of 1940, enacted October 8, 1940, is retroactive so as substantially to increase the income tax of the respondents for 1938, does such application deprive the respondents of property without due process of law, within the meaning of the Fifth Amendment to the Constitution of the United States?

If question 1 (both (a) and (b)) be answered in the negative, consideration of questions 2 and 3 will be unnecessary. If question 2 be answered in the negative, consideration of question 3 will be unnecessary.

THE STATUTE

These cases are controlled by the Revenue Act of 1938 (52 Stat. 447). The provision directly applicable is § 112(b)(7)(E)(i). Also pertinent are or may be § 112(b), subdivision (5) and the balance of (7); § 113(a), subdivisions (6) and (8); § 115, subdivisions (a) and (c); and § 117, subdivisions (a), (b) and (c). The Commissioner also claims that § 501 of the Second Revenue Act of 1940 is relevant. All the above sections except § 113(a)(6) and § 117, subdivisions (a), (b) and (c) are set forth in Appendix A to the Commissioner's brief. The last-named sections are set forth in Appendix I to this brief. Excerpts from the Congressional Committee Reports with respect to § 501, above-mentioned, are set forth in Appendix A to the Commissioner's brief. Sections 112(b)(7) and 501 are also set out in the Record (R. 61, 66).

STATEMENT OF THE CASE.

(1) OUTLINE OF THE ISSUES.

The case involves income tax for the year 1938 *i.e.* whether the shareholders of a corporation received a taxable distribution in December, 1938 from its "earnings and profits".

It is stipulated that, under principles of accounting and of corporation law, the corporation in question had no accumulated undivided profits and surplus, but rather a capital deficit (R. 33). The corporation not merely had no earnings and profits according to principles of accounting and corporation law; so far as here material, it had not *realized* any capital gain.

It is further stipulated that the liquidation here was carried out in contemplation of a statutory provision expressly applicable thereto (R. 37).

Said statutory provision was § 112(b)(7) of the Revenue Act of 1938, which provided that upon a complete liquidation of a corporation in December 1938, the shareholders might elect not to be taxed upon their own capital gain, but to be taxed as a dividend upon their pro rata share of the earnings and profits of the corporation (inclusive, of course, of any capital gain actually realized by the corporation itself and therefore included in its earnings and profits).

The problem presented in the case is therefore whether there is any applicable provision of statute or regulation under which, contrary to the language of § 112(b)(7), the corporate deficit must be deemed to have been converted into a corporate surplus.

The Commissioner issued his deficiency letter, not upon the theory that this result was reached by the applicable 1938 Act itself or any regulation under it, but upon the theory that, by retroactive amendment, § 501(a) of the Second Revenue Act of 1940 was applicable (R. 13).

Both Courts below held that this was so, and the Circuit Court of Appeals for the Ninth Circuit thereupon held that such retroactive application was unconstitutional. The Commissioner now argues alternatively that the 1940 Act need not to be considered, and that a sentence out of Treasury Regulations 101 (art. 115-3), in effect in 1938, should be construed to have itself required the conversion of deficit into surplus.

(2) RESPONDENTS' POSITION.

1. That the express provisions of the Revenue Act of 1938, pursuant to (and in admitted conformity with) the terms of which respondents carried out this transaction, indisputably provide that respondents are not to be taxed as a dividend in respect of an amount of a taxable gain by the corporation exceeding the corporation's actual earnings and profits.

2. That the meaning of the statute was not altered by the regulation (Art. 115-3 of Reg. 101) that gains within the purview of § 112 are brought into earnings and profits to the extent recognized under the statute.

3. That § 501(a) of the Second Revenue Act of 1940 is not applicable to the facts of this case since it applies only to gains *realized* by a corporation.

4. That in any event the provisions of the 1940 Act were prospective only and not retroactively amendatory of the 1938 Act.

5.² That if the provisions of the 1940 Act were retroactively amendatory of the 1938 Act, it was because of a provision of the 1940 Act which was stated to be effective in respect of *all* former revenue acts, and which under the facts in this case would have to be applied (so as to increase the tax of the respondents) to a provision two years earlier which had specifically provided the nature and amount of tax to be levied upon the particular transaction, and that under such circumstances its application would be unconstitutional.

(3) THE FACTS AS TO THE LIQUIDATION IN 1938.

The facts were stipulated (R. 30-39):

The John H. Wheeler Company was a California corporation. During the years 1925 to 1929 it issued its par value capital stock of \$491,800 for property worth that amount (R. 32). From 1931 to 1937 it sold most of such property for less than cost (R. 17-18) and thus incurred a capital deficit. As of December 1938 its capital deficit was \$47,501.61.

On May 27, 1938, Congress enacted § 112(b)(7), in effect inviting liquidations of corporations to take place in December 1938 upon the basis that an individual shareholder might then elect not to be taxed upon the capital gain, but only to be taxed, as on a dividend, on

"so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated * * *"

On this basis, as the corporation had a deficit, Mr. Wheeler would have no further tax to pay; and the same would of course be true of the other respondents.

It is stipulated that it was

"After giving consideration to the application of Section 112(b)(7) of the Revenue Act of 1938" (R. 34)

that the stockholders dissolved the corporation on December 2, 1938; and that the respondents exercised the election to be taxed for 1938 under that statute. The Treasury Regulations provide that such election cannot be withdrawn or revoked. Article 112(b)(7)-2 of Treasury Regulations 101. It is stipulated that no claim is made by the Commissioner that the proceedings under § 112(b)(7) were defective or incomplete (R. 37).

The situation is not claimed to have been affected by the next three Revenue Acts, namely, the Internal Revenue Code, 53 Stat. Part 1, the Revenue Act of 1939, 53 Stat. 862, and the (First) Revenue Act of 1940, 54 Stat. 516.

(4) THE DEFICIENCY ASSESSMENT IN THIS CASE—PURPORTING TO APPLY THE 1940 STATUTE TO THE 1938 TRANSACTION.

In his deficiency letter in 1941, the Commissioner took the position that § 112(b)(7) of the 1938 Act had been so amended by the new § 501 of the Second Revenue Act of 1940 that the Company's earnings upon the sale of its properties at a loss from 1931 to 1937 should be based on what the Company's transferors paid for the property rather than on the Company's cost of the property (R. 12-13).

The cost to the transferors to the Company of the properties had been \$304,684.49. That was the basis the law required the Company to use in computing its own income tax on the sale of the properties from 1931 to 1937. § 113(a)(8). (R. 33).

If corporate earnings were to be calculated on transferor's cost, they would have amounted to \$126,860.32:

Corporation's cost	\$491,800.00
Transferors' cost	304,684.49
	<hr/>
	\$187,115.51
Adjustments not involved in the case.	6,800.52
	<hr/>
	\$180,314.99
Actual corporate deficit.....	47,501.61
	<hr/>
Earnings determined by Commissioner	\$132,813.38
Less Tax Court reduction....	5,953.06
	<hr/>
	\$126,860.32

At the effective capital gains rate of 15% which would have been applicable if the shareholders of the Company had not elected to come under § 112(b)(7), (see § 115(c) and § 117(b) and (c)(1)), the tax for example on the shareholder John H. Wheeler¹ would have been about \$23,825 upon the complete liquidation of the Company in December, 1938:

Fair market value of property received by him in liquidation (R. 34)	\$312,335.92
Basis of his stock	153,505.01
<hr/>	
A gain of	\$158,830.91
1/2 of gain	\$ 79,415.46
Tax at 30%	\$ 23,824.64

Had it been liquidated under § 115(c), the tax to John H. Wheeler would therefore have been considerably less than under the assessment actually made on the application by the Commissioner of the 1940 Act to § 112(b)(7). The deficiency determined by the Tax Court was \$28,123.46 (normal tax of 4% and progressive surtax running up to 55% applied to \$63,430.16, his share of the "earnings"). The Commissioner's brief is in error in saying the contrary (at pp. 39, 42 and fn 29); the source of the error is evidently in the Commissioner's overlooking the 15% rate (30% on one-half the gain) under § 117(c)(1) where (as here) the shares had been held for more than 24 months.

¹John H. Wheeler, whose estate is one of the respondents, owned 50% of the shares. The four other respondents each owned 10%.

In liquidating under § 115(c), moreover, the shareholder would have had the tax basis for the assets received on liquidation increased by the full amount of his gain, namely, \$158,830.91. Under § 112(b)(7), on the Commissioner's theory, his tax basis would have been increased by only \$63,430.16, his share of the "earnings" (§ 113(a)(18)) and he would have had to pay another tax on a gain of almost \$90,000 had he made an immediate resale of the assets.

There is no finding, and no evidence that the corporation *would have been* liquidated under these conditions at all. *Certainly*, it would not have been liquidated under § 112(b)(7).

And there is no suggestion that the corporation was being used to avoid surtax on current income, or, that its stockholders were afraid of penalty therefor. Its regular practice had been to pay its entire income to its stockholders in annual dividends (R. 18).

To summarize, and using the shareholder John H. Wheeler as an example: As the law was in 1938, by electing to come under § 112(b)(7), the liquidation of the Company was substantially tax-free; but if the Company had been liquidated under § 115(c)—the provision ordinarily applicable to liquidations—the tax would have been \$23,824.64. Under those circumstances, § 112(b)(7) was obviously the preferable provision to elect. On the Commissioner's construction of § 501 of the 1940 Act, however, the tax under § 112(b)(7) is \$28,123.46 (with an increase in tax basis of only \$63,430.16), as opposed to the tax of \$23,824.64 under § 115(c) (with an increase in tax basis of \$158,830.91). Under *those* circum-

stances, § 115(c) would have been the preferable section to elect.²

(5) CIRCUMSTANCES UNDER WHICH § 501 OF THE SECOND REVENUE ACT OF 1940 CAME TO BE ENACTED.

A series of events relating to gains realized by a corporation (and therefore unlike this case, in which the corporation never realized a gain) gave rise to § 501 (a) of the Second Revenue Act of 1940.

On March 27, 1939, the Third Circuit Court of Appeals, in an opinion by Circuit Judge Davis (concurring in by Judges Buffington and Maris) held, in *Commissioner v. F. J. Young Corporation*, 103 F. (2d) 137, that a realized gain in a tax-free corporate reorganization became a part of earnings and profits at once and before it was recognized for income tax purposes under § 112 of the Revenue Act of 1928. The circumstances were later summarized by House Report 2894, 76th Cong., 3d Sess. as follows:

For example, on January 1, 1930, the X Corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was \$100. The fair market value of the stock in the Y Corporation received by the X Corporation was \$1,000. On

²Section 112(b)(7), of course, had application only to the tax of the *shareholders* upon a corporate liquidation. In no event does a corporation realize any gain or loss upon the distribution of its assets in kind in complete liquidation. Article 22(a)-21 of Treasury Regulations 101.

April 9, 1930, the X Corporation declared a cash dividend of \$900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, \$900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner v. F. J. Young Corporation*, 103 Fed. (2d), 137).

X corporation had realized a gain of \$900 on the exchange of its property for the stock of Y Corporation (*Marr v. United States*, 268 U. S. 536). The Third-Circuit Court of Appeals held that such realized capital gain or loss was to be brought into earnings and profits (with the incidental consequences upon the corporation's dividends), even though it had not yet become recognized because of the postponement provisions of § 112.

The House Report proposed legislation to overrule the *F. J. Young* case, saying that it was contrary to "the rule applied by the Treasury" (in Art. 115-3 of Treasury Regulations 101), in which "taxpayers generally have concurred", that

"Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The House Report concluded that this was the true view of the law and therefore recommended that it be enacted into statute.

The Senate Report was substantially to the same effect (S. Rep. 2114, 76th Cong. 3d Sess.); and the proposed legislation became a part of the Second Revenue Act of 1940 as § 501 (§ 115(1) of the Internal Revenue Code), the provision being (in part)

"The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation * * * (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain."

"Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

The amendment thus applied, and only applied, to gain or loss realized from a sale or other disposition of property, as was indeed, appropriate to its purpose of overruling *Commissioner v. F. J. Young Corporation* and of confirming a Treasury Regulation which had similar application.

Its purpose and effect was to confirm that when gains or losses have been realized, the time when and the extent to which they are brought into earnings and profits are governed by the provisions of § 112 for their recognition.

(6) HISTORY OF THIS LITIGATION.

Under this sub-heading, we are not discussing the merits, but merely outlining the various positions taken by

the Courts below and the parties. We think that such an approach may be helpful in this particular case, in which the ultimate issue has proven curiously elusive, as evidenced by the fact that both parties are here taking positions different from those taken by either Court below.

As this case necessarily involves several groups of concepts—"gain or loss", "realized", "recognized", "earnings and profits", and "dividends"—each of which has a long history of its own in income tax law, and as to each of which there are a number of provisions of statute and regulation which interplay, it is not surprising that although the Tax Court and the Circuit Court of Appeals decided the case on one issue, they disagreed in their conclusion, or that now both petitioner and respondents agree that the issue decided by the lower courts (a serious constitutional issue) can be avoided and the case be decided on other grounds.

Both Courts below assumed that the Second Revenue Act of 1940 retroactively governed this 1938 liquidation, so that the only question to be determined was its constitutionality. The Tax Court held it constitutional, and the Circuit Court of Appeals held it unconstitutional. Under these circumstances, the grant of a writ of certiorari naturally followed.

The petitioner argues here as his first point that the Courts below did not need to consider the 1940 amendment because the case should be governed in the petitioner's favor by Art. 115-3 of Treasury Regulations 101. That article had not been relied upon by the petitioner in his deficiency letter (R. 10-14).

As his second point, the petitioner supports the point that was assumed by both Courts below, viz. that the Second

Revenue Act of 1940 applies (if constitutional); and he then argues that it is constitutional.

We agree with the petitioner that the 1940 Act, the sole subject of analysis by the Courts below, need not have been considered. Thus the first point both of the petitioner and the respondents is that the case should properly be determined under the applicable 1938 Act itself.

Our first point is that the 1938 Act is plain on its face. The petitioner counters that there is ambiguity in the statutory phrase "earnings and profits of the corporation", and that resort must be had in its construction to the 1938 Regulation, Art. 115-3.

The respondents' replies are (1) That there is no ambiguity in the phrase "earnings and profits of the corporation", which is a long-standing phrase in the income tax acts, and (2) that in any event the Regulation is inapplicable.

The second parts of both briefs—petitioner's and respondents'—deal with the Act of 1940. The first question is whether the 1940 Act (whether prospective or retroactive) is applicable at all to the facts of this case. The next question is whether the 1940 Act is prospective in terms, or whether it retroactively applies to the 1938 Act. If it does not retroactively apply to the 1938 Act, the 1938 Act remains governing and the respondents prevail. If it does retroactively apply to amend the 1938 Act, the constitutional issue must then, but only then, be squarely faced.

SUMMARY OF ARGUMENT

PART ONE.

THE 1938 ACT.

The term "earnings and profits" has uniformly been held to be an accounting concept, defined by this Court in *Edwards v. Douglas*, 269 U. S. 204, to mean "undivided profits or surplus". The latter is a well-known accounting term. The Ways and Means Committee at the time of the 1940 Act agreed that the computation of earnings and profits "should be made conformably to the best accounting practice".

In applying the above principles, the cases have uniformly held that only *realized* gains could be taken into account in computing corporate earnings. That, plus the fact that "earnings and profits" is an accounting concept, excludes the possibility of using transferor's cost rather than corporate cost in computing corporate earnings. Accountants compute corporate earnings from the sale of property on what the corporation paid for the property—they are not interested in what the corporation's transferor paid for the property. If property cost the corporation's transferor \$100,000 but cost the corporation \$200,000 and was sold by the corporation for \$150,000, every accountant would determine that the corporation had lost \$50,000 on the transaction. The fact that the corporation (because it used transferor's basis for income tax purposes) had to pay an income tax of, say, \$7,500 based upon a fictitious gain of \$50,000, would be relevant in computing the earnings of the corporation only because earnings would be *further*

reduced by the \$7,500 tax that had to be paid upon the transaction.

The Treasury Regulation relied on by the Commissioner has never been treated by any court as requiring the use of transferor's basis in computing earnings and profits. The Regulation is applicable only to gains or losses "within the purview of § 112", i.e., gains or losses which have been realized but which because of the tax-free exchange provisions of § 112 are not recognized until a later date. That was the *F. J. Young Corporation* case. The Company in the instant case had no gains or losses within the purview of § 112. When it bought the property for its stock it made a purchase, not a sale. When it sold the property later at a loss, it realized no gain the recognition of which was postponed. It was merely required to take the low basis of its transferors for its own income tax purposes under § 113(a)(8).

We pass to the alternative source relied upon by the petitioner—§ 501 of the Revenue Act of 1940.

PART TWO.

THE 1940 ACT.

The Commissioner can derive no aid from § 501 since it is in terms applicable only to *realized* gains and losses. The Company could *realize* no gain by selling for less than cost. Before § 501 a court had held that mere realization was sufficient to have a gain taken into earnings. § 501 added the requirement of *recognition* (so that in cases where a recognition was postponed a gain would be taken into earnings at the later date when recognized). § 501 did

not subtract the requirement of *realization*. In fact, the section uses the word "realized" four times and is applicable only to "realized gains or losses".

It was assumed by both Courts below that the 1940 Act was retroactive. This appears to us to pay insufficient respect to the established doctrine that, in order to avoid grave constitutional questions, statutes are to be construed, wherever reasonably possible, as prospective. That doctrine has had particular application where Revenue Acts are concerned. As the 1940 Act, if retroactive, would amend (i) *all* prior Revenue Acts, and (ii) in this case an Act which was of specific application to liquidations "in December 1938" and was relied upon by these taxpayers in making an election offered by its terms, the presumption against retroactivity becomes particularly strong.

Finally, if the issue of constitutionality must be faced, it appears that if the Court is to hold this statute constitutional, it must go the full length of laying down a rule that no Revenue Act can be unconstitutional on the ground of retroactivity. This would overrule a line both of decisions and of *dicta* (appearing in opinions of the present Chief Justice, Mr. Justice Holmes, Mr. Justice Brandeis, Mr. Justice Roberts and Mr. Justice Cardozo), in which it has been recognized that retroactive revenue statutes may be unconstitutional if they exceed the bounds of what is "permissive". But this is the first case in which the Court has been confronted with a Revenue Act whose alleged retroactivity is applicable not merely to the earlier part of the same year or to the preceding year or indeed to any limited number of years, but to *all* of the years without limitation. And the earlier statute which on the facts of this particular

case is alleged to have been retroactively amended, is a specific statute which contained an "invitation" to the taxpayers to undertake this particular transaction "in reliance" upon it.

We are not, of course, arguing that the relation of the Congress to the taxpayer is susceptible to legal definition in terms of "invitation" and "reliance". These are merely used as apt words to identify the type of statute which admittedly the Congress had enacted in 1938, to-wit one in which it provided that particular legal consequences would attach to particular transactions (complete liquidations effected during the month of December 1938).

ARGUMENTPART ONETHE 1938 ACTPOINT IUNDER THE LAW IN EFFECT IN 1938, THE COMPANY
HAD NO EARNINGS AND PROFITS.(1) THE 1938 ACT IN ITS TERMS SUPPORTS THE
RESPONDENTS' POSITION.

This point does not seem to be seriously disputed by the petitioner and was assumed in respondents' favor by both Courts below. Otherwise, of course, no question of retroactive application of the 1940 Act could arise. Nor would there be need to appeal to any Regulation (as the Commissioner now does in his Point I).

The material provisions of the 1938 Act are:

"Sec. 112 RECOGNITION OF GAIN OR LOSS.

"(b) *Exchanges Solely in Kind.*

"(7) *Election as to recognition of gain in certain corporate liquidations.*

"(E) *Non-corporate shareholders.*

"(i) There shall be recognized [to the shareholder], and taxed as a dividend, so much of the gain [of the shareholder] as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913
* * *"

It is thus provided that:

(1) Some, but not all, of the "gain" is to be recognized.

(2) "The earnings and profits of the corporation" (not the taxable income of the corporation) determine the amount of the gain to be recognized to the shareholder on liquidation.

(3) The tax thereon to the shareholder is to be "as a dividend."

(2) HISTORY OF THE APPLICABLE TERMS OF THE 1938 ACT.

(a) "Earnings and Profits."

In 1938, the statute contained no definition of the term "earnings and profits" as used in § 115(a) (defining a dividend) or § 112(b)(7).³ That term was not contained at all in the Revenue Act of 1913. It first appeared in the Revenue Act of 1916 (§ 2(2)). The Revenue Act of 1917 (§ 1211), in addition to the term "earnings or profits", also used the term "undivided profits or surplus". There is no distinction between the terms "undivided profits or surplus" and "earnings or profits." *Edwards v. Douglas*, 269 U. S. 204; *Mertens, Law of Federal Income Taxation*, Vol. 1, § 9.03, p. 417, fn. 21.

It was stated with respect to the 1918 Act, and has since been universally accepted, that the Congress intended the use of the term "earnings and profits" in the ordinary accounting understanding. In *Commissioner v. James*, 49 F. (2d) 707 (1931) the Circuit Court of Appeals for the Second Circuit said, at p. 708:

³The term is used in the disjunctive in § 115(a) and in the conjunctive in § 112(b)(7), but no point is made of that difference. Both phraseologies are used interchangeably throughout this brief.

"In employing the phrase 'earnings and profits' in Section 201 [of the Revenue Act of 1918] we think Congress intended the use of the term in the ordinary accounting understanding * * *"

This was in accord with the general rule that terms used in the Revenue Acts, unless specially defined, are used in their ordinary, every day sense. *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370; *Woolford Realty Co. v. Rose*, 286 U. S. 319, 327; *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, 560; *Deputy v. du Pont*, 308 U. S. 488, 498.

So also at the time of the enactment of § 501 of the Second Revenue Act of 1940, the Ways and Means Committee stated that, consistently with the rules there laid down, it was contemplated that the computation of the earnings and profits "shall be made conformably to the best accounting practice." (Report No. 2894, 76th Cong. 3d Sess., p. 43).

The phrase "earnings and profits" in the Revenue Acts is uniformly used in contradistinction to the term "capital".

In the instant case the Company paid \$491,800 by issuing its stock worth that amount for property worth that amount. The entire \$491,800, the par amount of the stock issued, was set up on the Company's books as capital.⁴

⁴Under California law the full market value of the assets transferred became capital of the corporation. Capital stock was issued therefore in a par value equal to the amount thereof, and accordingly no part of it was surplus available for distribution to stockholders. Civil Code of California, §§ 290, 323. See e.g. as to the date of incorporation of the Wheeler Company (1925), *Kerr's Cyc. Codes of Calif.* (1920, Civ. Code Part One pp. 410 and 488; and Hillyer's Consol. Supp. thereto, 1921-1925). *Dominquez Land Corp. v. Daugherty*, (In Bank 1925) 196 Calif. 468, 477; 238 Pac. 703, 706-7.

The transferors had paid less than \$491,800 for the property; but the Company realized no "earnings and profits" from the transfer to it. The property was subscribed for in par value capital stock, and the Treasury Regulations have long provided that a corporation realizes no gain or loss on the original issue of its own stock. See Treasury Regulations 101, Article 22(a)-16.⁵ By the same token a corporation could not realize earnings and profits by selling, for less than cost to the corporation, the property which it had acquired for its stock. From *Doyle v. Mitchell Brothers Company*, 247 U. S. 179, to date, it has been settled that a taxpayer must be allowed to get his cost back on the sale before he can be treated as realizing income; that the conversion of property into money without gain does not result in earnings. As this Court said in the *Mitchell Brothers* case, at p. 185:

"Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the gross income received from all sources; and by applying to this the authorized deductions we arrive at net income. In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

⁵"The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock."

Accordingly, the Company realized no earnings or profits on a sale at a loss.

In *Edwards v. Douglas*, 269 U. S. 204, *supra*, this Court defined the term "earnings or profits", as contained in the Revenue Act of 1917, as meaning "undivided profits or surplus." Faced with a statute which contained both terms, it held that they meant the same, reversing the Court below which had held to the contrary.

The Company in the instant case had no undivided profits or surplus (R. 33, 41, 43). Accordingly, the Company could have no "earnings or profits", as defined by this Court.

(b) "Realized" and "Recognized."

Realization of gain or loss is in large measure a factual concept; *recognition* of gain or loss is wholly a concept of the taxing act. As to realization, the first question always is: has the taxpayer in fact made or lost money on the sale? The question whether a gain shall be "recognized" for the purpose of the taxing act depends upon whether the taxpayer is to be taxed thereon at once or is not to be taxed thereon until some later occasion.

Under the Revenue Act of 1913, when income taxation was a comparatively simple matter, realization and recognition coincided. Because of decisions of this Court that gain or loss was "realized" in connection with certain corporate reorganizations (*Rockefeller v. U. S.*, 257 U. S. 176, *Cullinan v. Walker*, 262 U. S. 134, *Marr v. U. S.*, 268 U. S. 536), the Congress, in § 202(c) of the Revenue Act of 1921, 42 Stat. 227, followed by § 112 of the Revenue Act of 1928, 45 Stat. 791, and its successors, provided that

although such gain or loss was *realized*, it would not, in certain types of corporate reorganizations, be *recognized* for income tax purposes until a later date. Thus recognition was in certain cases postponed until *after* realization. A gain could be realized but not recognized.

The Congress then determined, in order to prevent avoidance of income tax, that in certain situations a corporation should be required, for the purpose of *recognition* of gain, to take the tax basis of its transferor. This was true in the case of transfers to controlled corporations, § 113(a)(8). The concept of *realization*, being a factual one, remained unaffected. A corporation might sell property at a loss and still be subject to income tax. See *Perthur Holding Corp. v. Commissioner*, 61 F. (2d) 785, discussed at page 26, *infra*.

(c) "Realized" and "Recognized" as Applied to "Earnings and Profits."

The cases dealing with earnings and profits have always held that no gain or loss can come into the earnings and profits of a corporation until it has been realized. We know of no case to the contrary. In other words, the only gains or losses which affect a corporation's earnings are actual gains or losses, i.e., those realized. The question of recognition, which was wholly an income tax concept, had no bearing upon a corporation's earnings.

For reasons of convenience, the Treasury in its Regulations has provided since 1934 (Treasury Regulations 86, Article 115-1) that a realized gain or loss should not be taken into the earnings or profits until it was recognized. At least one Circuit Court of Appeals decision refused to

follow that concept, *Commissioner v. F. J. Young Corp.*, 103 F. (2d) 137 (C. C. A. 3d, per Davis, J.), and accordingly the Congress enacted it into law in § 501 of the Second Revenue Act of 1940.

However, as will be shown more fully in Part Two of this brief, the Congress did not by § 501 abolish the concept that a gain or loss must be realized before it can enter into the computation of earnings. § 501 applies only to *realized* gains or losses; such indeed are its express terms.

What the Commissioner is attempting to do in this case, is to reverse his field and to claim that his Regulation and § 501 apply to *recognized* but *unrealized* gains or losses. A reading of his Regulation and of the section makes it apparent that they apply only to realized but *unrecognized* gains or losses, i.e., gains or losses the recognition of which is postponed until a later date. The Commissioner's own brief supports the same conclusion, since he refers to the provisions directing the "*nonrecognition of gain or loss*", "*gains and losses not recognized for the purpose of computing taxable income*", etc. (pp. 17, 18 of the petitioner's brief).

(d) "Taxable Income."

It has been well settled for many years, both by Court decision and by Treasury Regulations and rulings, that the term "earnings or profits" is not the same as taxable income. See the cases and rulings cited and discussed in Appendix II to this brief, many of which were decided in the 1920s and early 1930s. The rule works both ways. Some items which are not taxable income increase earnings

and profits, and certain adjustments which do not reduce taxable income do reduce earnings and profits. Thus, earnings and profits may be either more or less than taxable income, depending on the circumstances. Both the Commissioner and taxpayers have relied on the rule where it was to their advantage to do so.⁶

The only reason that the Company, under § 113(a)(8), was required to compute its taxable income on a sale of its property by using the tax basis of its transferors, was that in a double check against possible avoidance of tax,⁷ the Congress had provided that not only did the transferors retain their low tax basis on the shares which they received (§ 113(a)(6)), but also the Company had the same low tax basis in computing its taxable income on sale of the property which it acquired (§ 113(a)(8)). The Revenue Acts recognize a fictitious gain because the corporation is required to use a low basis for income tax purposes. The cases dealing with § 113(a)(8) make it clear that a corporation *realizes* no gain upon the sale of its property at a loss. In *Perthur Holding Corp. v. Com'r.*, 61 F. 2d 785 (C. C. A. 2d, 1932), cert. den. 288 U. S. 616, the Court said (pp. 785-6):

⁶For instance that rule was applied three times by the Commissioner and the Tax Court in computing the Company's earnings and profits in this case. Earnings were increased \$203,085.19 above taxable income by dividends which were not taxable income (R. 17-18); decreased by \$27,553.18 of losses which were not allowable for income tax purposes (R. 18); and decreased by \$5,953.06 of income taxes which were not deductible for income tax purposes (R. 81).

⁷The revenue is amply protected by taxing the shareholder's profit twice: once to the corporation when it sells the property and once to the shareholder when he sells the stock. There is no reason to tax it a *third* time as a dividend.

"The taxpayer was a corporation with an authorized capital of \$260,000, none of which had been issued. In December, 1925, it issued \$250,000 of its shares to one, Kuttroff, in exchange for land in New York which at the time was worth that amount, and which it sold in 1926 at a small loss. This it deducted in its return for that year, but the Commissioner struck out the deduction, and in its place assessed as a deficiency, a tax levied upon the difference between the proceeds of the sale in 1926 and the value of the land on March 1, 1913, Kuttroff having bought before that date.

* * * * *

"The exchange took place after the Revenue Act of 1924 had *thrown upon the company the tax on Kuttroff's income*; it was a consequence with notice of which the company was charged and which it could escape. The only possible objection is under the Fifth Amendment, on the notion that the tax takes property without due process of law; and it has indeed been sustained when the result was to affect transactions which took place before the tax was imposed (*Nicholas v. Coolidge*, 274 U. S. 531, 47 S. Ct. 710, 71 L. Ed. 1184, 52 A. L. R. 1081; *Blodgett v. Holden*, 275 U. S. 142, 48 S. Ct. 105, 72 L. Ed. 206). But, so far as we know, it never has been, when the tax impinges prospectively, for the root of the evil is the inability of the parties to count upon the burdens they assume." [Emphasis ours]

(c) "Corporate Cost" or "Transferor's Cost."

With respect to the particular issue involved in this case, namely, whether earnings and profits of a corporation should be based upon corporate cost or upon transferor's

cost, the Courts have been uniform in holding that corporate cost must be used. See the cases cited and discussed in Appendix III to this brief. Rarely has there been such uniformity upon a tax question. If this Court were to hold otherwise, it would have to overrule every case that has ever been decided on the point, including numerous decisions of the Tax Court upon a question of accounting. Cf. *Dobson v. Commissioner*, 320 U. S. 489.

There is not a single case holding that corporate earnings and profits are to be figured on transferor's cost in any proceeding arising under the Revenue Act of 1938 or any prior Act. Indeed, three Tax Court decisions, after the enactment of § 501 of the Second Revenue Act of 1940, refused so to hold with respect to taxpayers not affected by such section. (See Appendix III to this brief).

There is no support for the suggestions by the Commissioner in his brief that there was "a doubt" or a "doubtful" point (pp. 10, 15, 20), that the law was "unsettled" (pp. 12, 36), that there was a "single decision" (pp. 11, 32), and that there was "no basis" (pp. 12, 34) for the rule relied on by the respondents in determining that the Company had no earnings or profits.⁸

(3) THE 1938 ACT AS APPLICABLE TO THIS TRANSACTION WAS NOT AFFECTED BY THE TREASURY REGULATION (Art. 115-3).

The only reason which the Commissioner gives in his brief as justifying his position that corporate earnings and

⁸The Commissioner's brief appears to rely on the fact that some of the cases supporting the Respondents' position were decided after 1938. That there are a number of recent cases on the point is in the respondents' favor rather than otherwise, and may well assist this Court in its determination of what the rule was under the Revenue Act of 1938.

profits were not in 1938 to be based on corporate cost, is a provision of the Treasury Regulations, first included in article 115-1 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, and repeated for the 1938 Act in Art. 115-3 of Treasury Regulations 101, which reads as follows:

"Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The Commissioner in his brief (pp. 22-23) complains that the cases which have held that corporate earnings and profits are to be based on corporate cost have either overlooked or disregarded the above regulation. The reason is obvious. It is patently inapplicable. It says nothing about the *basis* on which earnings and profits from the sale of property are to be determined.

As evidence of the inapplicability of the Regulation to the case under review, it should be noted that in a number of cases cited in Appendix III to this brief, the Commissioner did not even cite the regulation to the Court. He did not even refer to it in his deficiency letter in the instant case (R. 13).

The Regulation does not apply to all gains and losses. It applies only to gains and losses "within the purview of section 112." Such gains and losses are gains and losses which have been realized, but the recognition of which for income tax purposes has been postponed under § 112 until some later date.

The Company realized no gain "within the purview of section 112" either when it issued its stock for property or

when it sold that property for less than cost. The Treasury Regulation above-quoted is inapplicable to the instant case.

And as the Commissioner's brief correctly takes the position that § 501 "wrote into all the Revenue Acts the rule stated in the Regulations" (p. 22), if the Regulation be inapplicable, § 501 is equally inapplicable.

PART TWO.

THE 1940 ACT

The position taken by both Courts below was that the deficiency assessment was not supported by the 1938 Act. This was the same position assumed by the Commissioner in the deficiency letter and in making his second point in his brief before this Court. In other words, both Courts below, the Commissioner in his deficiency letter and the Commissioner in his second point here, assume that the question arises under the 1940 Act. The problem arises under two headings: (1) application of the Act, and (2) constitutionality of the Act if applicable.

POINT II.

§ 501 OF THE SECOND REVENUE ACT OF 1940 IS INAPPLICABLE TO THE FACTS OF THIS CASE.

(a) This is true of its language.

This is the position taken by necessary implication by the petitioner himself in the first point of his brief, wherein he argues that § 501 of the 1940 Act was to the same effect as the 1938 Regulation.*

*Petitioner says that by the 1940 Act "Congress wrote into all of the Revenue Acts the rules stated in the Regulations" (p. 22 of his brief).

We think that in this respect the petitioner is right, and is supported both by the language of the new Act and by the evidence of Congressional intent provided by the House and Senate Reports. The language of the material part of § 501 is this:

"The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation * * * (2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain."

"Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided."

The subject-matter is the manner of employment of *realized* gain in computing earnings and profits. That the section applies only to *realized* gains or losses is apparent from the use of that word four times, once in the first sentence, twice in the second sentence, and once in the third sentence. If, and only if, a gain or loss is *realized*, (1) that gain or loss for the purpose of determining earnings and profits will be

determined upon the "adjusted basis for determining *gain*", i.e., rather than the basis for determining loss, where that differs from the former (see the discussion in Appendix IV to this brief), and (2) that gain or loss shall be taken into earnings and profits at the later date when it is *recognized* in computing taxable income.

The word "realized" was not in the House version of § 501; it was inserted in the Senate. It must have been intended to have some meaning since it was used four times in three sentences.

✓ The statute has nothing to do with the question as to *when* gain is realized. Realization remains a condition precedent to its application.

In the vast majority of cases, of course, the gain or loss is realized by the same party that originally acquired the property. Such realized gains and losses are not to be taken into earnings and profits until such later date as they are recognized.

This was, as the petitioner rightly argues, confirmatory of the Commissioner's earlier Regulation (Art. 115-3) that

"Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section."

The problem characteristically arises when the taxpayer is not the corporation, but is one who receives a dividend from the corporation. He must then determine whether the corporation had realized any "gains or losses" recognition of which has been postponed. But this does not for one moment mean that either the 1938 Regulation or the 1940

Act constituted an enactment to the effect that gain which had not been realized was ever to be taken into earnings.

(b) The Congress evidenced no other intention.

The reports to both Houses of Congress stated that the rule which they intended to promulgate was a rule "applied by the Treasury under existing law" in which "taxpayers generally have concurred." There is here no ground for the suggestion that the Congress intended to reverse all the decided cases. (See Appendix III.)

The Ways and Means Committee stated that the rule applied by the Treasury under existing law is that "gain or losses which are *not* recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits" and that the theory which it wished to overrule was "the theory that gain or loss, even though *not* recognized in computing net income, nevertheless affects earnings and profits" (H. R. No. 2894, 76th Cong., 3d Sess., page 41). [Emphasis ours] As the Commissioner says in his brief (p. 30), the purpose of Section 501 was to ratify "the rule expressed in the Treasury Regulations".

As an example¹⁰ of the type of decision which it wished to overrule, the Ways and Means Committee cited *Commissioner v. F. J. Young Corporation*, 103 F. (2d) 137 (C. C. A. 3d, 1939). That case involved a situation clearly within the scope of the Treasury Regulations and wholly

¹⁰The only other example given relates to depletion, not to income realized from a sale of property. As this Court has held, a corporation's income is realized pre-depletion. Depletion allowances are a matter of legislative grace. *Stanton v. Baltic Mining Co.*, 240 U. S. 103.

unlike the instant case. In the *F. J. Young Corporation* case, the taxpayer corporation exchanged property which had cost it \$36,000 for stock in another corporation worth \$957,000. The taxpayer corporation realized \$921,000 profit on the exchange (*Marr v. U. S.*, 268 U. S. 536, *supra*), none of which gain was recognized to it under § 112 since it was a tax-free exchange under that section. If it had not been for § 112, the realized gain would have been taxable income.

The *Young* case did not involve the question of whether the corporation's earnings should be based on corporate cost or transferors' cost; the two were the same, since the corporation whose earnings were being determined in the *Young* case was itself the transferor. The question in the case was as to the time when an admittedly realized gain should come into earnings and profits of the corporation—i.e., whether when realized, or at the later date when recognized upon a subsequent sale of the stock. The Court held that the profit came into the earnings and profits of the transferor corporation at the time it was realized and was not postponed, for the purpose of computing earnings and profits, until the profit was recognized for income tax purposes. This is the type of case that is referred to by Mr. Paul in the quotation at pages 18 and 19 of the Commissioner's brief.

Neither the *Young* case, the Treasury Regulation, Mr. Paul, nor the new statute, had application to cases other than those in which a corporation realized a gain or loss.

The Congress indicated no wish to overrule the holding of *Commissioner v. W. S. Farish & Co.*, 104 F. (2d) 833 (C. C. A. 5th, 1939), and of the other cases cited in Appendix III to this brief, that earnings and profits on the

sale of property are to be determined on corporate cost rather than transferor's cost.

The only other case cited by the Congressional Committees was *Commissioner v. Sansome*, 60 F. (2d) 931 (C. C. A. 2d, 1932), cert. den. 287 U. S. 667 (cited by the Commissioner at p. 19 of his brief). There a corporation was reorganized in a tax-free reorganization into a new corporation with the same shareholders. At the time of the reorganization, the corporation had accumulated earnings and profits which were set up on the books of the reorganized corporation as "Surplus and undivided profits" (22 B. T. A. 1171, 1175). The question was whether such earnings and profits retained their status as earnings and profits of the reorganized corporation. The Court held that they did, holding that a tax-free reorganization was a transaction which did not "break the continuity of the corporate life."

In the case under review, however, the transferors were not corporations but individuals who could have no "earnings or profits" the status of which was to continue unchanged. There was no "corporate life" which could continue unbroken. Moreover, the Company had no "surplus and undivided profits." The Commissioner cannot argue here in favor of disregarding the corporate entity of the Company, since any tax to the shareholders upon the liquidation of a corporation is based solely and completely upon a regard for the corporate entity. If that be disregarded there could be no tax upon liquidation.

And the fact that the Company was required to pay income tax upon the sale of the property based upon the cost of such property to its transferors does not call § 501 into

play where it realized no gain.¹¹ The Commissioner has admitted that the gain or loss which enters into the computation of earnings and profits under § 501 is not the same as the gain or loss used in computing taxable income. In T. D. 5024, 1940-2 C. B. 110, 113, promulgated under § 501, it is stated:

"The 'recognized' gain or loss for the purpose of computing earnings and profits is determined by applying the recognition provisions to the realized gain or loss computed under the provisions of section 115(1) [section 501] as distinguished from the realized gain or loss used in computing net income."

That § 501 was intended to affect only realized but unrecognized gains or losses (and not recognized but unrealized gains or losses) is further supported by the wording of the subcommittee's original recommendation for legislation:

"Earnings and profits.—Your subcommittee recommends that chapter I of the Internal Revenue Code be clarified in order that the unrecognized gain or loss upon the sale or exchange of property by a corporation not be reflected in its earnings or profits account. This rule is in accord with the previous practice adopted by taxpayers and the Bureau of Internal Revenue alike and set forth in the income-tax regulations." [Report of a subcommittee of the Committee on Ways and Means (76th Cong., 3d Sess.) on proposed excess-profits taxation and special amortization, dated August 8, 1940 (p. 14).]

¹¹In fact, the payment of the additional income tax based on transferors' cost would actually have diminished the earnings and profits of the Company below what they would have been if its tax basis had been corporate cost. *Commissioner v. James*, 49 F. (2d) 707, *supra*.

A *non-recognition* provision cannot be applicable unless there is a realized gain or loss to be recognized at a later date.

In other words, the *F. J. Young Corporation* case had held that *realization* was all that was required to bring a gain into earnings. The Treasury Regulations and later § 501 *added* the requirement of *recognition*. They did not subtract the requirement of *realization*.

We have found no case, except the decision of the Tax Court below, which has held that § 501 is applicable to cases in which the corporation realized no gain upon the sale of its property. The Tax Court's opinion shows that it obviously did not give full consideration to the point, but devoted its energies to the question of unconstitutional retroactivity.

(c) And the decided cases have so applied the new section.

We have been able to find only two reported cases applying the provisions of § 501. Both confine § 501 to situations in which a gain or loss has been realized and the recognition of that realized gain or loss has been postponed under § 112. In other words, both decisions accord with the distinction we have urged in this brief.

In *Commissioner v. Shenandoah Co.*, 138 F. (2d) 792 (C. C. A. 5th, 1943), the taxpayer had realized in 1936 and 1937 certain profits from the installment sale of property. Such profits were, because of the provisions of § 44 of the Revenue Act of 1936, taken into taxable income in later years. The question was whether such concededly realized gains increased the earnings and profits of the corporation in their entirety or only to the extent that they

were used in computing taxable income for the years in question. The Commissioner took the position that under § 501, earnings and profits were the same as taxable income. The Court rejected that interpretation and held that corporate earnings were increased by the entire amount of the realized gain, stating at p. 794:

“* * * All that Section 501 does, all that it was intended to do, is to limit usable earnings and profits from sales of property to that portion of the gain realized which is taxable, and there is nothing in it which restricts such usable profits to those gains only which are returned for taxation in the year of their realization.* * *”

§ 501 was thus confined to gains “within the purview of section 112” and was not extended to gains within the purview of § 44.

Another example of the proper application of § 501, is *Butter-Nut Baking Company*, 3 T. C. 423 (1944) in which the taxpayer realized a gain in 1938 from insurance proceeds with respect to property which had been destroyed by fire, the recognition of which gain was postponed under § 112(f) of the Revenue Act of 1938.

For the year 1941, in computing its excess profits tax, the taxpayer attempted to include in its accumulated earnings and profits as of the beginning of 1941 (for invested capital purposes) the amount of the gain which it had realized on receipt of the insurance proceeds. The Tax Court properly held that under § 501 the gain realized in 1938 could not enter into the computation of earnings and profits until it was recognized, saying, at pp. 426-7:

“It thus becomes apparent that for the taxable year here at hand we have a statutory direction that

earnings and profits may be increased by gain only to the extent that such gain was recognized in the computation of net income, whereas under the law affecting the *National Grocer Co.* case [1 B. T. A. 688], if gains were merely *realized*, they could properly be included in the determination of invested capital. Inasmuch as the \$13,049.16 was not recognizable gain to the petitioner in 1938, it may not be used as a part of petitioner's earnings and profits accumulated at the beginning of the taxable year, under section 718 of the Second Revenue Act of 1940. The respondent did not err in disallowing the amount in the computation of invested capital."

§ 501 has also been applied in two unreported District Court cases to the realized gain or loss on an intercorporate liquidation under § 112(b)(6). *Cranson v. U. S.* (D. C. Cal.) 44-1 U. S. T. C. paragraph 9113. *Shuman v. U. S.* (D. C. Cal.) 44-1 U. S. T. C. paragraph 9143.

It is reasonable to provide (as § 501 does) that realized gains shall be taken into earnings when recognized. It is completely unreasonable to say that fictitious gains which have never been realized should be taken into earnings and profits at all.

(d) Other applications of § 501 by the Commissioner are consistent.

The Commissioner himself has interpreted § 501 very narrowly, even as applied to realized gains and losses, and has in his published rulings to date strictly confined the section to gains or losses realized in transactions where recognition is postponed under § 112. For instance, he ruled that § 501 was not applicable to the following classes

of losses which are not allowed to be used in computing net income: (1) wash sale losses disallowed under § 118; (2) capital losses not taken into account in computing taxable income under § 117 because of the loss limitation provisions; and (3) losses disallowed because of a sale to a shareholder of the corporation under § 24(b) (T. D. 5024, 1940-2 C. B. 110, 113).

And in this case, the Company's *realized* loss on the sale of its property for less than cost was not an unrecognized loss within the purview of § 112. The recognition of the realized loss was not postponed under § 112. The loss was not taken into account in computing the Company's net income since, under § 113(a)(8) the Company was compelled to use a low transferor's basis for income tax purposes. The mere fact that a loss on a sale is not allowed for income tax purposes does not mean that it does not reduce earnings and profits. For example, a sale at a loss prior to March 1, 1913 (although never allowed for income tax purposes) is still taken into account in computing accumulated earnings and profits. *Lynch v. Hornby*, 247 U. S. 339. See also the examples cited above.

POINT III.

IT IS A REASONABLE CONSTRUCTION OF THE 1940 ACT THAT IT IS PROSPECTIVE IN APPLICATION. THAT CONSTRUCTION SHOULD BE ADOPTED TO AVOID A GRAVE CONSTITUTIONAL QUESTION.

(1) THE CONSTITUTIONAL QUESTION IS A SERIOUS ONE.

There are two reasons why the 1940 Act, if construed to have retroactively imposed a tax upon this transaction,

would present an unusually grave constitutional issue. These are:

First, if the 1940 Act is retroactive at all, the Act is retroactive so as to amend *all* prior Revenue Acts. This is conceded. Accordingly, the Act would not merely go beyond the period recognized in *Welch v. Henry*, 305 U. S. 134,—“during the year of the session in which the statute is enacted, and in some instances during the year of the preceding session,” 305 U. S. at p. 148,—but would attempt “to reach events so far in the past” as to present the question expressly left open at 305 U. S. 148, *supra*. Indeed, because it attempts to reach *all* past events, it goes to the maximum possible extent.

Accordingly, we suggest that this is the case in which, if the 1940 Act is to be considered applicable at all to the instant case, this Court will have to go to the length of holding what it has heretofore steadfastly refused to hold, viz., that under no circumstances can there be an unconstitutionally retroactive taxing act. So to hold, would be to say that the use of the phrase “permissive retroactivity” was unnecessary and unjustified, nay even misleading to the taxpaying community.

On that view, the opinion of Mr. Justice Holmes (concurrent in by Mr. Justice Brandeis, Mr. Justice Sanford and the present Chief Justice) in *Blodgett v. Holden*, 275 U. S. 142, 147, the opinions of Mr. Justice Holmes and of Mr. Justice Brandeis (both concurred in also by the present Chief Justice) in *Untermeyer v. Anderson*, 276 U. S. 440, 446, the dissenting opinion of Mr. Justice Roberts (concurred in by Mr. Justice Holmes, Mr. Justice Brandeis and the present Chief Justice) in *Coolidge v. Long*, 282 U. S. 582, 606, the *ground* of decision, recognized by Mr.

Justice Roberts for the Court, and *relied on* by Mr. Justice Brandeis, Mr. Justice Cardozo and the present Chief Justice, in *Helvering v. Helmholz*, 296 U. S. 93, as well as the opinion of the Court in *Welch v. Henry*, 305 U. S. 134, 148, *supra*, would all fall within the same condemnation.

It is of course open to this Court, when principle compels, to announce a fundamental change in the law, having the effect not merely of reversing prior decided cases, but of undermining the reasoning upon which those prior cases had at the time been criticized by the dissenting justices. *Erie Railroad Co. v. Tompkins*, 304 U. S. 64.

But in this case the same members of the Court who united in the various dissenting and concurring opinions have at least once actually held a tax law unconstitutional if retroactively applied. In *Helvering v. Helmholz*, 296 U. S. 93, the Court was unanimous that the Fifth Amendment applied to tax legislation. Mr. Justice Brandeis, Mr. Justice Cardozo and the present Chief Justice placed their concurrence upon the sole ground that retroactive application of the statute there under consideration would be unconstitutional. Their concurrence (at p. 98) was "on the ground last stated in the opinion," written for the Court by Mr. Justice Roberts:

"Another and more serious objection to the application of Section 302(d) in the present instance is its retroactive operation. The transfer was complete at the time of the creation of the trust. There remained no interest in the grantor. She reserved no power in herself alone to revoke, to alter or to amend. Under the revenue act then in force the transfer was not taxable as intended to take effect in possession or in enjoyment at her death. *Reinecke v. Northern Trust Company*, 278 U. S. 339. If Section 302(d)

of the Act of 1926 could fairly be considered as intended to apply in the instant case its operation would violate the Fifth Amendment. *Nichols v. Coolidge*, 274 U. S. 531."

White v. Poor, 296 U. S. 98, decided on the same day as the *Helmholz* case, was to the same effect.¹²

The rule applicable to the present situation was forecast not only in concurring and dissenting opinions, but in a recent opinion of the Court, *Welch v. Henry*, 305 U. S. 134, 147:

"In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. *Nichols v. Coolidge*, 274 U. S. 531, 542; *Untermeyer v. Anderson*, 276 U. S. 440, 445 (citing *Blodgett v. Holden*, 275 U. S. 142, 147); *Coolidge v. Long*, 282 U. S. 582. Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process. But there are other forms of taxation whose retroactive imposition cannot be said to be similarly offensive because their incidence is not on the voluntary act of the taxpayer."

¹²The *Helmholz* and *Poor* cases were decided in 1935 shortly after the Law Review prediction (quoted in the Commissioner's brief at p. 45) that the doctrine of "arbitrary retroactivity" was "as dead as a wager of law."

The instant case satisfies each of such requirements of arbitrary and oppressive retroactivity. The respondents could not reasonably have anticipated such a change in the statute as the Commissioner claims that § 501 effected; and they had made a voluntary election based upon the law in force in 1938.

Second, in this case, the taxpayers, at the time of the particular voluntary acts (deciding to liquidate the Company and electing to come under § 112(b)(7) instead of § 115(c)) undertook them in contemplation of a statute expressly passed to inform them as to the nature and amount of the tax to be imposed upon the transaction, and which in effect invited the transaction.

Few sections of the revenue law have been more specific and limited in their application than that section of the Revenue Act of 1938 which provided the tax effect of a liquidation which

"occurs within the month of December 1938."

And it is stipulated that it was pursuant to the provisions of that Act that the Company was dissolved on December 2, 1938, and that the respondents filed their elections under the thereby newly enacted § 112(b)(7)(D).

(2) WHEN THE CONSTITUTIONAL QUESTION IS GRAVE, THE STATUTE SHOULD NOT BE CONSTRUED TO HAVE RETROACTIVE APPLICATION, UNLESS SUCH CONSTRUCTION IS COMPELLED BY ITS TERMS.

This doctrine, familiar and established in many branches of constitutional law, has had emphatic recognition in the field of revenue law.

Perhaps it was already forecast *sub silentio* when, in *Nichols v. Coolidge*, 274 U. S. 531, 543, Mr. Justice Holmes, Mr. Justice Brandeis, Mr. Justice Sanford and the present Chief Justice concurred in the result, but not in the opinion, in a case holding that a certain revenue enactment was unconstitutionally retroactive.

At the next term of Court, the doctrine found expression on behalf of the same four justices, in another case in which they concurred with a decision that a particular retroactive Revenue Act could not be applied to a transaction antedating its passage. The concurring opinion (of four Justices in an equally divided Court) was written by Mr. Justice Holmes, *Blodgett v. Holden*, 275 U. S. 142, 147-148:

"Although research has shown and practice has established the futility of the charge that it was a usurpation when this Court undertook to declare an Act of Congress unconstitutional, I suppose that we all agree that to do so is the gravest and most delicate duty that this Court is called on to perform. Upon this among other considerations the rule is settled that as between two possible interpretations of a statute, by one of which it would be unconstitutional and by the other valid, our plain duty is to adopt that which will save the Act. Even to avoid a serious doubt the rule is the same. [citing cases]. Words have been strained more than they need to be strained here in order to avoid that doubt."

This has been the view adhered to in the subsequent cases mentioned under subdivision (1) of this Point.

We come now to the application of the principle to this particular statute, and suggest that although the Court may properly (at least in a case so extreme as this) be prepared,

in Mr. Justice Holmes' phrase, to "strain words" in order to avoid imputation to the Congress of an intent to have done a serious retroactive injustice, the statute in the present case is so phrased that no straining of words is necessary to reach the right result.

(3) THE STATUTE IS REASONABLY OPEN TO THE CONSTRUCTION THAT IT WAS INTENDED TO BE PROSPECTIVE IN APPLICATION, EXCEPT THAT IT WAS TO APPLY TO THE FULL YEAR DURING WHICH ENACTED (1940) AND THE PRIOR YEAR (1939). INDEED, THIS IS THE TRUE CONSTRUCTION.

The relevant portions of the new section—§ 501 of the Second Revenue Act of 1940, 54 Stat. 974, are the following:

TITLE V—AMENDMENTS TO INTERNAL REVENUE CODE

"SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

"(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

* * * * *

"(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

"(c) *Under prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the

date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any Court of the United States."

It will be apparent that Congress made a distinction between the application of the new section to the Internal Revenue Code (adopted in 1939) and its application to prior acts.

It is significant that § 501 is the first section of Title V of the Second Revenue Act of 1940, which is called "AMENDMENTS TO INTERNAL REVENUE CODE". This is convincing evidence that the only statute intended to be amended by § 501 was the Internal Revenue Code, which is effective only for the taxable years 1939 and later years.

As to the Code, it said in subsection (a) that the Code "is amended", and that the amendment is effected "by inserting" certain specific new subsections.

As to the Code, there is added the succinct subsection (b), entitled: "Effective date of amendment", in which it is expressly stated that the amendment "shall be applicable" to taxable years after December 31, 1938.

The subsection (c) relating to prior acts, contains neither of these expressions. It is stated neither that "they are amended", nor that an amendment "shall be applicable" to the years governed by them. Within this subsection (c) there is indeed further expressed recognition that the section is an amendment to the Code rather than to the acts prior to the Code, for the amendments are described as

"amendments made to the Internal Revenue Code by subsection (a) of this section."

The function of subsection (c) next appears as one of stating the manner in which such amendments (to the Code) are to be "effective" *in respect of* the prior Acts. This effectiveness is to be "as if" they were a part of each such Revenue Act on the date of its enactment. In other words, they are not "to be" a part of such Revenue Act, but are "to be effective as if" they were a part of such Revenue Act; and "they" are "the amendments to the *Internal Revenue Code*."

The function of subsection (c) was thus to determine the status of earnings and profits accumulated in 1938 and prior years (i.e., years when the Revenue Act of 1938 and prior acts were controlling). This was to prevent any argument that the status of earnings and profits realized in 1938 and prior years was to be frozen (i.e. their status determined under the Act in effect when they were realized) and that only earnings and profits realized under the Code were to be determined by the new rule. As the Finance Committee said, § 501(c) was intended to effect "the application of a uniform rule *for the determination of the earnings and profits of all corporations for all prior taxable years.*" [Emphasis ours] The Commissioner's brief (p. 38) omits the italicized portion of the quotation.

In *Butter-Nut Baking Company*, 3 T. C. 423 (1944), the amount which the taxpayer wished to include in accumulated earnings and profits as of 1941, had been realized in 1938, and under the law then in force had already become a part of earnings. If it had not been for § 501(c) applying the rule of § 501 to all past earnings whenever realized, the Court might have felt bound to determine their status as earnings by the law in force when they were realized. Cf. § 501(a) which uses the expression "under the law ap-

plicable to the year in which such sale or disposition was made."

The Commissioner's brief (pp. 26, 27) cites various sections of the Revenue Act of 1942, all, so far as relevant, relating to adjustments in taxable income, for the proposition that since the language used in such sections is similar to that used in § 501, the latter section must have been intended to affect income tax liability for all prior revenue acts. The Commissioner overlooks the fact that § 501 does not deal with adjustments to taxable income as such, but only with earnings and profits, which, as such, are not taxable but may affect tax liability of shareholders not only in the year they are realized but in later years as well.

If § 501 had been intended to affect *tax liability* for all past years, it would have been easy to say so. Cf., for example, the wording of the following retroactive provisions which specifically amend prior acts: § 213(f), (g), (h) and (i) of the Revenue Act of 1939; and §§ 137 and 186(a) of the Revenue Act of 1942. See also §§ 121, 122 and 127 of the Revenue Act of 1943 in which it is stated that provisions "having the effect of the amendments made" to the Internal Revenue Code "shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after" a particular date.

The retroactivity provision of § 137 of the Revenue Act of 1942 is particularly interesting when it is compared with the provisions of § 501(c) of the Second Revenue Act of 1940, set out *supra*. § 137(b) reads as follows:

"(b) Retroactive Effect.—For the purposes of the Internal Revenue Code and the Revenue Acts of 1928, 1932, 1934, 1936 and 1938, the amendments made to the Internal Revenue Code and those Acts

by subsection (a) of this section shall be effective as if they were a part of the Internal Revenue Code and such revenue Acts on the respective dates of their enactment."

There prior Acts as well as the Internal Revenue Code are expressly amended.

We suggest that there is here (1) not merely no need to strain words in order to reach the construction necessary to avoid the constitutional question, and indeed (2) more than sufficient to meet the test of reasonably possible interpretation required in the opinions of Justices Holmes, Brandeis, and the present Chief Justice, but that there is indeed (3) sufficient to indicate that it would be plain *error* to construe the statute retroactively.

Nor is this view changed by the addition, made while the statute (after enactment in the House) was being considered in the Senate and which appears in its last sentence, to the effect that "nothing in this subsection shall affect" liabilities of taxpayers in litigation on September 20, 1940. This has ample scope to protect taxpayers in respect of the years 1939 and 1940 (in the latter case prior to the enactment of the statute): The status of earnings realized in 1938 and prior years could and does affect *tax liability* for 1939 and later years. There is no need to throw its application back to *tax liability* under the 1938 and prior Acts. Even if there were, its presence in the statute could easily be ascribed to an intention by the Senate *ex majore cautela* to protect taxpayers from injustice.

To convert such a sentence into one evidentiary of an intention on the part of the Senate to insure that injustice be done to taxpayers all the way back for as many years as the revenue authorities could show that actual litigation

had not yet commenced, as the petitioner asks this Court to do (his brief, pp. 25-29), would be, we respectfully submit, an undue exercise of zeal in the collection of taxes. It would ascribe motives to Congress which this Court would be slow to impute. And the Treasury is entitled to the same consideration. The present Secretary of the Treasury had testified before the Ways and Means Committee at the time it was considering the Revenue Bill of 1934:

"As a matter of public policy the Treasury believes that it is inadvisable to attempt to go back into past years and now, in effect, tax what was not taxable then." [Statement of the Acting Secretary of the Treasury regarding the preliminary report of a subcommittee of the Committee on Ways and Means (December, 1933) p. 17.]

Nor would any particular purpose be served by making the statute of unlimited retroactivity for the purpose of tax liability. So far as tax collections for most years prior to 1939 were concerned, they would fall fortuitously upon taxpayers who were unlucky enough not to be protected by the statute of limitations or unfortunate enough (as in the instant case) not to have begun litigation by September 20, 1940. Certainly a ten year retroactivity would have caught all such taxpayers. However, unlimited retroactivity was needed in order to prevent the status of earnings and profits realized in prior years from being frozen under the provisions of such prior Acts, thus affecting tax liability for the year 1939 and later years. Many corporations had been in existence as far back as 1913, and it was accordingly necessary to have a uniform rule "for the determination of the earnings and profits of all corporations for all prior taxable years."

(4) THE REVENUE ACT OF 1938 HAD ALREADY BEEN REPEALED WHEN THE SECOND REVENUE ACT OF 1940 WAS ENACTED.

The Revenue Act of 1938 had been repealed effective February 11, 1939, by § 4(a) of the Internal Revenue Code Enabling Act (Public Act No. 1, 76th Cong., 1st Sess., 53 Stat. Part 1. All the rights accruing or accrued at that time had been continued in effect, including the right of the respondents here to compute their taxes under the provisions of the 1938 Act existing prior to its repeal. § 4(b). Unless the 1938 Act were expressly stated to be *amended*, no amendment affecting tax liability thereunder should be deemed to be made by § 501. The Court below said (R. 129):

"It is impossible to amend a law that no longer exists."

POINT IV.

IF THE 1940 ACT IS RETROACTIVE WITHOUT LIMITATION, IT IS UNCONSTITUTIONAL.

If we must face the issue that was faced by both the Courts below, then we submit that the Circuit Court of Appeals for the Ninth Circuit rather than the Tax Court reached the right conclusion.¹⁸

In Point III we have indicated the unlimited sweep of retroactivity (to *all* prior Revenue Acts) and the unusually cruel incidents of its application to a taxpayer who had

¹⁸The decision of the Tax Court was by a single judge (Judge Arnold), and being on a constitutional question, was of course a decision of pure law.

framed his transaction in accordance with the precise Congressional invitation in the 1938 Act, now assumed to have been retroactively amended.

As shown in the statement of facts: (1) There is no evidence and no finding that the transaction would have occurred except for the Congressional invitation. (2) There is no evidence and no finding that the taxpayers in fact needed to liquidate their corporation for fear of the effect of legislation against so-called personal holding companies or of penalties thereunder. (3) It affirmatively appears that they had been paying in dividends the full amount of the corporation's income. (4) Had they liquidated under the usual statute, § 115(c), they would have paid at the 15% capital gains rate, and in the aggregate would have paid a lower tax and had a higher tax basis than they have after electing to come under § 112(b)(7), if we assume that the 1940 amendment changes the 1938 Act.

Therefore, assuming that Congress intended to, and did, retroactively amend its 1938 invitation, it not merely withdrew a privilege, but it tricked these taxpayers into paying a higher tax—not merely higher than was payable in 1938 under § 112(b)(7) but higher than if they had elected to liquidate in the usual way under § 115(c). We submit that neither in the statute itself, nor in the reports of the House and the Senate (which have been made available as appendices to the petitioner's brief), nor indeed in our general knowledge of the concern for common fairness which the Congress shows in the enactment of its revenue laws and which this Court invariably accords to Congress on principle, is there any justification for imputing to Congress the ingenious twist of the thumb-screw which the

petitioner has evolved from his misinterpretation of § 501 in this case.

But if we are wrong in all this, we submit that the only consequence must be that the time, long deferred, has now finally arrived at which this Court must hold an income tax act unconstitutional as in violation of the Fifth Amendment.

The Commissioner has purported to find some support for his views in three recent cases in various Circuit Courts of Appeals. Those cases are distinguished in Appendix V to this brief. For further review of the decided cases, we respectfully refer the Court to the opinion of Circuit Judge Garrecht for the 9th Circuit Court of Appeals, 143 F. (2d) 162 (R. 121-130).

CONCLUSION.

**THE JUDGMENT OF THE CIRCUIT COURT OF APPEALS
SHOULD BE AFFIRMED.**

Respectfully submitted,

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January 25, 1945.

APPENDIX I

Sections 113(a)(6), and 117(a), (b) and (c). Relevant Provisions of the Revenue Act of 1938 (in addition to those set forth in Appendix A of the Commissioner's brief)

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (unadjusted) of property.—The basis of property shall be the cost of such property; except that—

* * *

(6) Tax-free Exchanges Generally.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, the basis (except as provided in paragraph (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."

"SEC. 117. CAPITAL GAINS AND LOSSES.

(a) Definitions.—As used in this title—

(1) **CAPITAL ASSETS.**—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1);

(2) **SHORT-TERM CAPITAL GAIN.**—The term 'short-term capital gain' means gain from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such gain is taken into account in computing net income;

(3) **SHORT-TERM CAPITAL LOSS.** The term 'short-term capital loss' means loss from the sale or exchange of a capital asset held for not more than 18 months, if and to the extent such loss is taken into account in computing net income;

(4) **LONG-TERM CAPITAL GAIN.**—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

(5) **LONG-TERM CAPITAL LOSS.**—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such loss is taken into account in computing net income;

(6) **NET SHORT-TERM CAPITAL GAIN.**—The term 'net short-term capital gain' means the excess of short-term capital gains for the taxable year over the sum of (A) short-term capital losses for the taxable years, plus (B) the

net short-term capital loss of the preceding taxable year, to the extent brought forward to the taxable year under subsection (e);

(7) **NET SHORT-TERM CAPITAL LOSS.**—The term 'net short-term capital loss' means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year;

(8) **NET LONG-TERM CAPITAL GAIN.**—The term 'net long-term capital gain' means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year;

(9) **NET LONG-TERM CAPITAL LOSS.**—The term 'net long-term capital loss' means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

(b) **Percentage taken into account.**—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 18 months;

66 $\frac{2}{3}$ per centum if the capital asset has been held for more than 18 months but not for more than 24 months;

50 per centum if the capital asset has been held for more than 24 months.

(c) **Alternative taxes.**—

(1) **IN CASE OF NET LONG-TERM CAPITAL GAIN.**—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections

11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain."

APPENDIX II

Discussion of Cases and Rulings Showing that "Earnings and Profits" Differs from Taxable Income

"Earnings and profits" of a corporation clearly does not mean the same thing as "taxable income". The Treasury Regulations themselves admit this and provide that (1) all income exempted by statute from tax and (2) all income not taxable under the Constitution of the United States, although not included in taxable income, are included in "earnings and profits". Discovery and percentage depletion, although they reduce taxable income, do not reduce earnings and profits. Treasury Regulations 101, article 115-3.

The differences between taxable income and earnings and profits are many and have been set forth in a great many cases and rulings.

(1) *Examples Where "Earnings and Profits" Are More Than Taxable Income.*

The classic example of the clear distinction between taxable income and earnings and profits is contained in the decision of this Court in *Lynch v. Hornby*, 247 U. S. 339. In that case a corporation had large earnings and profits which had accrued prior to March 1, 1913, the effective date of the first income tax act. It was clear that those earnings and profits did not constitute taxable income to the corporation, but nevertheless, the Supreme Court held that they did constitute earnings and profits of the corporation so that any distribution from them would be a taxable dividend to the shareholders. That rule was more recently affirmed in *Helvering v. Canfield*, 291 U. S. 163, 167.

Dividends received by a corporation, although not included in taxable income under revenue acts prior to the Revenue Act of 1936, are nevertheless included in earnings and profits. The Commissioner has so ruled in the instant case, since he has included in the Company's earnings and profits \$203,085.19 of dividends which were not includible in its taxable income from 1926 to 1935 (R. 17, 18).

Similarly, a statutory net loss may be carried forward for the purpose of computing taxable income, but not for the purpose of computing earnings or profits of the year available for dividends. *R. M. Weyerhaeuser*, 33 B. T. A. 594 (1935).

The proceeds of an insurance policy are not taxable income, but they have been stated to be earnings and profits which are available for dividends. *Cummings v. Commissioner*, 73 F. (2d) 477 (C. C. A. 1st, 1934).

Moreover, on a tax-free merger under § 112, the accumulated earnings and profits of the merged corporation become earnings and profits of the continuing corporation, although they are obviously not taxable income to the continuing corporation. *Commissioner v. Sansone*, 60 F. (2d) 931 (C. C. A. 2d, 1932).

(2) Examples Where "Earnings and Profits" Are Less Than Taxable Income.

In those years in which the net capital losses of a corporation allowable for income tax purposes could not be in excess of \$2,000, a corporation with an ordinary income of a million dollars and a million dollar capital loss would have \$998,000 of taxable net income under § 22(a), but would have no earnings and profits. This rule has been followed uniformly by the Treasury (see I. T. 3253, 1939-1 C. B. 178 and § 115-12 of Treasury Regulations 111 issued under § 501 of the Second Revenue Act of 1940). The Commissioner has applied that rule in the instant case to decrease the Company's earnings by \$27,553.18 included in computing taxable income (R. 18). To the same effect are *Inland Investors, Inc.*, 44 B. T. A. 654 (1941), reversed on another issue, 132 F. (2d) 543 (C. C. A. 6th, 1942); and *Saxon Trading Corporation*, 45 B. T. A. 16 (1941). The rule has been held to be the same under § 501 (T. D. 5024, 1940-2 C. B. 110, 113).

A loss on a sale made by a corporation to a shareholder which is disallowed for income tax purposes under § 24(b) nevertheless reduces earnings and profits. The rule is the same under § 501 (T. D. 5024, 1940-2 C. B. 110, 113).

So also a wash sale loss under § 118, although not taken into account in computing taxable income, does reduce earnings and profits. The rule was the same under § 501 (T. D. 5024, 1940-2 C. B. 110, 113), until the specific amendment to § 501 made by § 146(a) of the Revenue Act of 1942.

Federal income taxes, although not deductible in computing taxable income, are deductible in computing earnings and profits. *Commissioner v. James*, 49 F. (2d) 707 (C. C. A. 2d, 1931). The Tax Court applied that rule in the instant case (R. 81).

So also, prior to the Revenue Act of 1936, an operating deficit from a prior year could reduce earnings and profits in a subsequent year. *Arthur C. Stifel*, 29 B. T. A. 1145 (1934). It could not, however, reduce taxable income.

Again, extraordinary expenditures and charitable contributions reduce the earnings and profits of a company. Such expenditures do not, however, reduce the corporation's taxable income. *Welch v. Helvering*, 290 U. S. 111; *Old Mission Co. v. Helvering*, 293 U. S. 289, 294.

Moreover, income realized on an installment sale of property, although not taken into taxable income in the year of realization, under § 44 of the Revenue Act of 1936, nevertheless is wholly taken into earnings and profits in that year. *Commissioner v. Shenandoah Co.*, 138 F. (2d) 792 (C. C. A. 5th, 1943). The rule has been held to be the same under § 501.

So far as we know, § 501 has not been construed to change the rule of any of the above cases.

Prior to § 501, an *unrecognized* gain or loss was taken into earnings and profits at the time it was realized. *Commissioner v. F. J. Young Corporation*, 103 F. (2d) 137 (C. C. A. 3d). § 501 changed that rule. However, no case had ever held that an unrealized gain or loss was taken into earnings at all. As the above cases show, only *realized* gains and losses affect the earnings and profits. Accordingly, § 501 which deals only with realized gains and losses, could have no application to the doctrines laid down in the cases cited in Appendix II and Appendix III to this brief.

APPENDIX III

Cases holding that a corporation's "earnings and profits" are based on corporate cost and not on transferor's cost.

By 1938, the rule that corporate earnings and profits derived from the sale of property were based on corporate cost and not upon transferor's cost was well settled; and the Commissioner relied upon it.

In *W. & K. Holding Corporation*, 38 B. T. A. 830 (1938), decided a month or two before the liquidation of the Company in the instant case, the Tax Court was presented with the problem of whether corporate earnings and profits should be based upon corporate cost or transferor's cost. The Government claimed that corporate cost should control. In holding that corporate cost (which, in that case, was lower than transferor's cost) should control, the Tax Court said, at p. 841:

"Earnings available for dividends are computed upon actual gains and losses of the corporation as of the date of the distribution."

The case involved § 115 of the Revenue Act of 1932.

Early in 1938, the Tax Court had decided *W. S. Farish & Co.*, 38 B. T. A. 150, in which the taxpayer had taken the position that corporate earnings and profits were to be determined on corporate cost rather than on transferor's cost. In that case the transferor's cost was less than corporate cost. The Tax Court had again held that corporate earnings should be based on corporate cost, saying at p. 158:

"The cost to a corporation of property exchanged for its capital stock is the fair market value of the stock so exchanged, and where there is no other method of determining the value of the stock, its value is held to be the fair market value of the prop-

erty exchanged therefor. *Ida I. McKinney*, [32 B. T. A. 450, aff'd 87 F. (2d) 811 (C. C. A. 10th, 1937)] *supra*; *Reliance Investment Co.*, 22 B. T. A. 1287; *Mead Realty Co.*, 21 B. T. A. 1062; *L. H. Philo Corporation*, 16 B. T. A. 130; *Realty Sales Co.*, 10 B. T. A. 1217.

"The cost to petitioner of the securities acquired in exchange for its capital stock was not less than \$1,118,084.65, the cost entered on its books. If petitioner thereafter ~~had~~ sold such securities for \$1,118,084.65, it would neither have derived a gain nor sustained a loss in fact, and its paid-in capital would have remained the same in amount, the form merely being changed from an investment in securities to cash. Under the statute it would have realized taxable gain in the amount of \$409,617.96, or the difference between the transferors' cost and the sales price, because it acquired the securities in a tax-free exchange. However, if petitioner has distributed such statutory *taxable income* to its stockholders, it would not have been a distribution out of 'gains and profits' but a liquidating dividend which, to that extent, would have invaded its paid-in capital."

The decision of the Tax Court was affirmed by the Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. W. S. Farish & Co.*, 104 F. (2d) 833). The Commissioner filed no petition for certiorari.

The Tax Court approved the doctrine of the *Farish* case as applied to the Revenue Act of 1928 in *A. and J. Inc.*, 38 B. T. A. 1248, 1258 (1938).

The Tax Court has also approved the rule of the *Farish* case as applied to § 115 of the Revenue Act of 1934 in *Dorothy Whitney Elmhirst*, 41 B. T. A. 348 (1940). Although the *Elmhirst* case was decided about six years after the promulgation of the Treasury Regulation relied

upon by the Commissioner in the instant case, the Commissioner did not even cite the Regulation to the Tax Court. Since the Commissioner conceded in the *Elmhirst* case that the Tax Court had already decided, under revenue acts prior to the 1934 Act, that corporate cost and not transferor's cost should control in the computation of earnings and profits, if the Commissioner had at that time considered the Treasury Regulation promulgated under the 1934 Act as relevant, he would certainly have cited it to the Tax Court.

Since the passage of § 501 in 1940, the Tax Court has reaffirmed the holdings of the above cases in at least three instances:

*Falkland Corporation** (CCH Dec. 12, 170-A) decided November 8, 1941, affirmed on stipulation by C. C. A. 2d (January 15, 1943) 44-1 U. S. T. C. Par. 9271, involving the Revenue Act of 1936 (corporate cost lower than transferor's cost).

Senior Investment Corporation, 2 T. C. 124, 139 (1943)** involving the Revenue Act of 1936 (corporate cost higher than transferor's cost).

Estate of Fred J. Fisher† (CCH Dec. 13, 734M), decided February 9, 1944 (corporate cost higher than transferor's cost), involving the Revenue Act of 1934.

In the *Falkland Corporation* case, *supra*, the Tax Court pointed out that in the *Elmhirst* case the Commissioner had not relied on the Treasury Regulation. The Tax Court

*Memorandum opinion (not officially reported).

**The dictum in the case with respect to the effect of § 501 of the Second Revenue Act of 1940, as applied to cases not pending on September 20, 1940, is, we believe, both ill-considered and erroneous. The case cites the Tax Court opinion of the instant case in support of its conclusion. In the *Senior Investment* case and the other two cases above cited the petition in the Tax Court happened to have been filed shortly prior to September 20, 1940, and § 501 was in terms inapplicable.

†Memorandum opinion (not officially reported).

refused to decide that the Treasury Regulation was applicable, and said that in any event it was "not effective to overcome the decisions". The decisions "interpreted the statute, not the regulation". As the Commissioner said in his brief in the Circuit Court of Appeals in the *Falkland Corporation* case (p. 11), the Tax Court "sustained the taxpayer's contentions (1) that an amendment of the statute and not a mere Treasury regulation was required to change the effect of law laid down by the Board and the courts, and (2) that the regulation was not in fact applicable here, since it involved a gain or loss realized, and the taxpayer had realized no gain or loss when it acquired in 1932 the stock which it sold in the taxable year, but merely made a purchase of such stock."

It is thus apparent that the rule has always been that earnings and profits of a corporation have been determined by using corporate cost rather than transferor's cost. The rule can work either for or against the taxability of a shareholder upon a distribution, and, where the rule was in his favor, the Commissioner has applied it. The rule as so laid down by the decisions is both logical and sound. There is no indication that the Congress intended to change it by § 501.

APPENDIX IV

True Purpose of §501(a)

§ 501(a) had two main purposes, both of which related only to realized gains or losses and the manner in which such realized gains or losses were to be reflected in earnings and profits.

The first purpose was to make clear that in the case of a realized gain or loss, earnings and profits were to be determined by using the adjusted basis "for determining gain", i.e., rather than the basis for determining loss, where that differed from the former. The report of the Senate Committee on Finance (Report No. 2114, 76th Cong., 3d Sess., p. 23) shows that the purpose of this provision was to prevent earnings and profits from necessarily corresponding to taxable income rather than to insure that earnings and profits should conform to taxable income. Indeed, the only example given with respect to the operation of this provision is an example where the taxable income was zero but earnings and profits were nevertheless decreased.*

*The Committee Report states: "The subsection provides that the gain or loss realized from the sale or other disposition (after February 28, 1913) of property shall, for the purpose of computing the earnings and profits (for any period beginning after February 28, 1913), be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain. For example, stock in the X corporation was acquired by the Y corporation prior to March 1, 1913, at a cost of \$90, its March 1, 1913, value was \$120, and in 1939 it was sold for \$100. The basis (under the law applicable to the year 1939) for determining gain is the cost or, March 1, 1913, value, whichever is higher. As the Y corporation received \$100 for the stock of the X corporation, and its value on March 1, 1913, \$120, exceeded its cost, \$90 (assuming that there are no adjustments to be made to the basis), the Y corporation realized a loss under the pro-

The second purpose of § 501(a) was to establish the rule that *realized* gains and losses, the recognition of which is postponed, are taken into earnings and profits only at the time and to the extent that they later become recognized gains or losses. That has been discussed at length in the body of this brief.

As further indication that the section was not intended generally to conform earnings and profits to taxable income, the third sentence provides that where "in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease [in earnings and profits] above provided." As stated in the report of the Committee on Ways and Means (Report No. 2894, 76th Cong., 3d Sess., p. 43) § 501(a), while "prescribing rules for certain cases *** contemplates that consistently with these rules the computation [of earnings and profits] shall be made conformably to the best accounting practice". There can be no doubt that under the best accounting practice corporations' earnings on the sale of property are computed on the basis of corporate cost and not on the basis of transferor's cost.

visions of this subsection of §20. If such a loss is recognized under section 112, the decrease in the earnings and profits accumulated by the Y corporation after February 28, 1913, as the result of this transaction in 1939 was \$20 notwithstanding provisions of the code to the effect that no deduction was allowable in computing net income."

APPENDIX V

**Recent cases in the Circuit Courts of Appeals relied upon by
the Commissioner on the issue of constitutional
retroactivity.**

The Commissioner's brief (p. 44) cites in favor of his position three recent Circuit Court of Appeals cases involving § 213(f) of the Revenue Act of 1939. *Wilgard Realty Co. v. Commissioner*, 127 F. (2d) 514 (C. C. A. 2d, 1942), cert. den. 317 U. S. 655; *Commissioner v. Corpus Christi Terminal Co.*, 126 F. (2d) 898 (C. C. A. 5th, 1942); and *D. W. Klein Co. v. Commissioner*, 123 F. (2d) 871 (C. C. A. 7th, 1941), cert. den. 315 U. S. 819. Under the principles declared in *U. S. v. Hendler*, 303 U. S. 564, it appeared that the transactions in the above cases, which had taken place in 1931 and 1932, would not have been tax-free reorganizations, but that, under § 213(f) of the 1939 Act, which was expressly made retroactive, the transactions were tax-free reorganizations.

The opinions in the *Corpus Christi* and *Klein* cases do not show that the taxpayer raised any issue under the Fifth Amendment. In the later *Wilgard Realty* case, the court was careful to note that the taxpayer believed when the exchange was made in 1932 that it was a "tax-free one" and that both the taxpayer and its controlling shareholder treated the exchange as a tax-free exchange. The Court said, at p. 517:

"Obviously, the petitioner has done nothing it would not have done had the law been, when the exchange was made, exactly what the 1939 enactment later made it. It has, therefore, not been the victim of any injustice and until it can show that it has been hurt it may not challenge the constitutionality of the statute."

The above rule cannot be applied to the instant case. At the time the respondents elected to come under § 112(b)(7), they rightly thought that the tax would be less under that section than under § 115(c). If § 501 were construed as the Commissioner claims it should be and applied to the year 1938, it would cause the taxpayers to pay more tax under § 112(b)(7) and have a much lower basis for the property received on liquidation than they would have had if they had liquidated the Company under § 115(c).

The Commissioner (at pp. 34-37 of his brief) sets forth an ingenious but specious argument to the effect that, regardless of the proper interpretation of a statute, the Congress can always retroactively amend it until that statute has been construed in a final decision by this Court. We know of no cases supporting the Commissioner's position; and he has cited none. The possibilities of capriciousness which such a doctrine would create are almost unlimited. Most statutory provisions never require a decision by this Court. In any event, that argument is not applicable to the instant case, for as far back as 1925 this Court had defined the term "earnings or profits" to mean "undivided profits or surplus". *Edwards v. Douglas*, 269 U. S. 204, *supra*.

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CHARLES ELMORE DROPLEY
CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1944

No. 354

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

against

ELLIOTT H. WHEELER, *et al.*, Executors of the
Estate of JOHN H. WHEELER, *et al.*,
Respondents.

**PETITION FOR REHEARING AND
MOTION TO WITHHOLD ISSUANCE OF MANDATE**

ELLIOTT H. WHEELER, *et al.*,
Executors of the Estate of JOHN
H. WHEELER, Deceased, *et al.*,
Respondents, .

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April 17, 1945.

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Respondents.

No. 354

**PETITION FOR REHEARING AND
MOTION TO WITHHOLD ISSUANCE OF MANDATE**

*To the Honorable the Chief Justice and the
Associate Justices of the Supreme Court of the
United States:*

Introductory

In this case (i) the deficiency assessment was based on a 1940 statute, (ii) which statute was the sole basis of the decision (a) of the Tax Court (that it was retroactively valid) and (b) of the Circuit Court of Appeals (that it was unconstitutionally retroactive).

And it was solely on the issue of the 1940 Act that the writ was granted in this case:

"The Circuit Court of Appeals for the Ninth Circuit has held Section 501(a) of the Second Revenue Act of 1940 to be unconstitutional. This

of course called for grant of certiorari" (Slip Op. 1). (Emphasis ours.)¹

This Court then decided the case on an entirely different point—that the case was ruled by a regulation first introduced in 1935, under the Revenue Act of 1934.²

It is not true, as the Court supposed (Slip Op. 3) that the Commissioner has "persisted in applying" his present interpretation of the regulation. He argued in other cases both in the Tax Court and in the Circuit Court of Appeals that it should be given our interpretation.

But the Tax Court was consistent in its rulings opposed to the interpretation now given by this Court.

The Court disposed of the Tax Court's decisions in the following sentence (Slip Op. 3):

"The only reason to doubt the *validity* of the regulation is found in certain² decisions of the Board of Tax Appeals and lower Courts, mentioned in the Tax Court's opinion." (Emphasis ours)

This Court thus assumed that the regulation was susceptible to only one *interpretation* and that the issue was as to its *validity*. We submit that if we can establish that there is an open question as to the *meaning* of the regulation, this Court should consider it upon a rehearing. We presume that this Court will be astute to avoid the peculiarly unfortunate position that must occur when the highest ap-

¹We assume that it is a fair assumption that, in the absence of a conflict of circuits (and there is none), the Court would not have granted certiorari merely to review the interpretation of the regulation; nor indeed did the 9th Circuit Court of Appeals interpret it.

²The "certain" decisions of the lower courts to which this Court referred were *all* the decisions on the subject.

pellate Court has been constrained to decide a point hardly noticed below and inadequately argued here. We are in effect appealing from this Court to this Court; and it is our first appeal on the issue on which the Court founded its first opinion.

We take the entire blame for not adequately carrying home to this Court on the first hearing that there was a serious issue to be considered as to the meaning of the regulation.

If we are right in our view that there be such an issue, we assume that the Court will wish to determine it, not *a priori* by merely reading the regulation, but in the light of its history. We will argue that after considering that history, this Court must come to the conclusion alternatively (a) that it misinterpreted the regulation, or (b) that at least the line of authority in the Tax Court supporting and applying the contrary interpretation is so strong that the question was not open in this Court if the rule in the *Dobson* case, 320 U. S. 489, at pp. 498-507, is still law.

This Court's disregard of the Tax Court's interpretation cannot be reconciled with the rule laid down in the *Dobson* case as to the weight to be attached to Tax Court decisions. It is noteworthy that on the very day that this Court's opinion was announced, the 6th Circuit Court of Appeals (in a case to which the 1940 Act was inapplicable) made a contrary decision upon precisely the same point, solely upon the ground that it was required so to do by the decision of this Court in the *Dobson* case. *Commissioner v. Fisher*, (C. C. H. Tax Service par. 9239). So dramatic a coincidence must at least result in this case causing a searching re-examination of the *Dobson* principle by the legal and accounting professions. We submit that under these circumstances it becomes fitting for this Court itself

to re-examine the grounds of its decision, when it be borne in mind that the circumstances under which it first came here for review necessarily deprived the Court of the full assistance of counsel upon the point upon which it was decided.

The earlier opinion of this Court proceeds throughout upon the assumption that there was something that may properly be called "the regulation". "The regulation" referred to is but the third sentence in a paragraph.

Under a basic principle in the interpretation of statutes, the paragraph must be read as a whole. When so read, it appears that the third sentence was in effect a footnote to the second sentence.

The applicable rule was stated for the Court by the present Chief Justice in *Helvering v. Morgan's, Inc.*, 293 U. S. 121, 126:

"But the true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part. See *Helvering v. New York Trust Co.*, 292 U. S. 455, 464."

The principle must be *a fortiori* applicable to a single sentence within a paragraph. And see *United States v. American Trucking Associations*, 310 U. S. 534, 542, 544.

Summary

First. The primary grounds for rehearing are:

1. That the Commissioner has not "persisted in" his present interpretation of the regulation.

2. That the Tax Court *has* persisted in the interpretation of the regulation contrary to that assumed by this Court.

Second. If we are right in either or both of these propositions, then the bases of this Court's earlier opinion fall, and it becomes appropriate in the interests of justice that there be a fresh examination of the regulation.

On such examination we will submit

(a) That the Tax Court's interpretation is correct when the sentence from the regulation is read in its context, which deals with actual gains and losses.

(b) That the Congress showed no intent to include in earnings and profits anything but actual gains and losses.

(c) That this Court's interpretation of the regulation produces distortion of earnings and profits in re-organization cases.

Third. If this Court does not wish to reconsider its interpretation, still the present case must be decided otherwise because of its special facts. Proceeding upon the assumption that the theory of this Court's decision is correct, the regulation cannot be applicable to turn the Wheeler Company's deficit into earnings.

(a) The transactions in question occurred prior to the first adoption of the regulation under the Revenue Act of 1934.

(b) If earnings and profits, under the theory of this Court's decision, be determined by taxable income, rather than actual income, the Wheeler Company still

had a deficit, for the non-taxable dividends to it must then be deducted.

ARGUMENT

PART ONE

The Court's Interpretation of the Regulation Cannot Be Supported.

I.

In six successive cases between 1938 and 1944 the Board of Tax Appeals and Tax Court gave to the statute an interpretation contrary to that assumed by this Court.

That was a reasonable interpretation.

Therefore the decision of this Court cannot stand without amounting to an overruling *sub silentio* of the *Dobson* case, 320 U. S. 489.

In each of the six cases the factual situation was like that in the *Wheeler* case. The taxpayer was a stockholder. The question was whether the taxpayer received a dividend out of earnings or profits. The corporation from which it received the dividend had in each case acquired property in a tax-free reorganization and had thereafter sold the property. The question was therefore whether the basis to the corporation was its own accounting basis or was its transferor's basis.

In each of the cases the Tax Court held that it was the actual basis of the transferee corporation and not the transferor's basis that governed.

The first case was *W. S. Farish & Co.* (July 22, 1938) 38 B. T. A. 150. As in *Wheeler*, transferee's basis was

higher than transferor's. Therefore the Commissioner claimed that transferor's basis governed. The Board wrote a long opinion to the contrary, holding that earnings or profits were related to *actual* gains and losses of the corporation as such. The opinion was reviewed by the Board. It was then affirmed on appeal in 1939 (C. C. A. 5th) 104 F. (2d) 833, and the Commissioner did *not* apply for a writ of certiorari.

The case was argued in the Board of Tax Appeals about three years after the adoption of the "regulation", but the regulation was not mentioned by the Commissioner. It is therefore impossible to say that he was then "persisting" in a position which he was not even suggesting.

The regulation had issued 3 years before—on February 11, 1935, under the Revenue Act of 1934.³

The second case before the Board of Tax Appeals came three months after the *Farish* case. *W. & K. Holding Corporation* (Oct. 1938) 38 B. T. A. 830. This case presented the same issue as in the *Wheeler* and *Farish* cases, but the position of the parties was reversed, as transferor's basis was higher than transferee's.

The Commissioner argued exactly the opposite of what he is arguing here. He argued that transferee's basis governs,—that earnings and profits under the statute mean actual earnings and profits.

We submit that this wholly destroys the assumption by this Court that the Commissioner "persisted" in the view that he has presented here.

³At the time of insertion in the regulation of the sentence under review, Mr. Justice Jackson was the chief legal officer of the Bureau of Internal Revenue.

The decision was in favor of the Commissioner. Again the case was reviewed by the whole Board, and although four members dissented, the dissenting opinion shows that it was based upon other grounds. Evidently the Board was unanimous in its adoption of the rule for which we are now, and the Commissioner was then, contending.

The third case was *Dorothy Whitney Elmhirst* (Feb. 1940) 41 B. T. A. 348. Here, as in the *Farish* and *Wheeler* cases, transferor's basis was lower, so the Commissioner was now arguing against the established rule. The 1934 Act was involved. Yet the Commissioner evidently did not rely on the regulation, and it is not mentioned in an extensive opinion. Again the decision was reviewed by the Board, and the already established rule was unanimously approved.

The fourth case was *Falkland Corporation* (not officially reported, C. C. H. Dec. 12, 170-A, decided Nov. 1941). Transferor's basis was lower, and the decision was in favor of the taxpayer corporation which was claiming a dividends paid credit.

Falkland was the first case in which the Commissioner based an argument upon the regulation. Indeed, he attempted to distinguish the next preceding (*Elmhirst*) case by saying that he had not there relied upon the regulation. Of course, the distinction was fallacious, because the meaning of the statute did not change depending upon what argument was made upon it.

The important point is that the fact that the Commissioner never argued that the regulation applied to a case of this character until July 1941—more than six years after the adoption of the regulation—shows how misled this Court was in supposing that the Commissioner had been persisting in applying the regulation. He just was not applying it at all; and it was not until after the enactment of the 1940 Act and after the deficiency assessment in the *Wheeler* case that he first argued that the regulation applied to a case of the *Wheeler* type.

But by that time the contrary interpretation of the regulation had been established by the three cases above cited. *Farish. W. & K. Elmhirst*. It had become established as strongly as any tax rule could ever be established by the Board of Tax Appeals, for in the three cases there had been an opportunity for the Commissioner to argue on both sides of the point, and every one of the three cases had been consistently decided and also reviewed by the full Board.

The fifth and sixth cases presented the same fact situation as the *Farish* case, and they followed and applied *Elmhirst*. They were *Senior Investment Corporation* (1943) 2 T. C. 124, 139, and *Estate of Fred J. Fisher* (not officially reported, C. C. H. Dec. 13,734M, Feb. 9, 1944). The *Fisher* case was the case affirmed on March 26, 1945, by the 6th Circuit Court of Appeals on the authority of the *Dobson* case.

The following quotations are characteristic of the Tax Court's decisions:

"Earnings available for dividends are computed upon actual gains or losses of the corporation as of the date of the distribution." *W. & K. Holding Corporation*, 38 B. T. A. 830, 841 (1938).

"It is the *actual* gain or loss which affects the corporation's capital and determines whether there is earned surplus, or a deficit which impairs the capital." *W. S. Farish & Co.*, 38 B. T. A. 150, 158 (1938).

"However, the gain or loss reflected by the use of the transferor's basis is not the true or actual gain or loss as it affects the capital of the corporation. Whether a corporation has an earned surplus or a deficit which impairs capital is to be determined on

the basis of the actual gain or loss, and the actual gain or loss is to be measured by the cost of the property to the corporation, which, in a case such as the instant one, is the fair market value of the property received in exchange for all of its capital stock." *Senior Investment Corporation*, 2 T. C. 124, 139 (1943).

The rule laid down by the Tax Court that corporate earnings and profits are to be determined by *actual* gains and losses was a reasonable rule and the one which causes less distortion in the long run than any other. Certainly there should be *compelling* reasons for abandoning it.

The Tax Court decisions interpreted a statutory phrase ("earnings and profits") which the Congress did not define until 1940. Accordingly, the statute which the Tax Court construed remained substantially unchanged from the Revenue Act of 1916 to the Second Revenue Act of 1940. If any presumption be applicable, it must be that Congress had knowledge of the Tax Court interpretation of the statute, which was re-enacted without change until the Second Revenue Act of 1940.

The rule relating to re-enactment of revenue acts by the Congress without change after they have received an administrative interpretation must be as applicable to a consistent line of decisions by the Tax Court as to a sentence in a regulation. Here the decisions were unequivocal; whereas the sentence in the regulation was, if not inapplicable, at least of doubtful applicability.

Indeed, this rule of law established by the Tax Court is likewise a rule of tax accounting, for it is dealing with a section of the statute whose purpose was to define the source of dividends, viz. (to quote the regulation) from "corporate earnings or profits". It is thus entitled to the

support of this Court under the language of the opinion in the *Dobson* case both as relating to law and as relating to accounting (pp. 502, 506):

"In deciding law questions courts may properly attach weight to the decision of points of law by an administrative body having special competence to deal with the subject matter. The Tax Court is informed by experience and kept current with tax evolution and needs by the volume and variety of its work. While its decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.

* * *

"We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit. The error of the court below consisted of treating as a rule of law that what we think is only a question of proper tax accounting."

The Wheeler Company had no economic gain from the sales of property at less than cost, and since it was required, in computing its income tax, to use the low basis of its transferors, it gained no tax benefit from such sales.

The Wheeler Company did not of course realize any actual gain on the sale of property at a loss, i.e. at less than the Company paid for it. As this Court said in *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 185:

"Understanding the term in this natural and obvious sense it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo."

We fail to understand what this Court means when it says in its opinion (Slip Op. p. 4):

"But to recognize the increment in value as affecting earnings and profits would no more harmonize with the taxless character of the transaction than to treat a realized gain as doing so."

It would appear to us that this Court's decision did recognize "the increment in value as affecting earnings and profits". The Wheeler Company could realize no gain by selling at a loss. What this Court has done has been to include in the Company's earnings and profits the increment in value which occurred while the property was held by the transferors and thus to recognize that increment in value as affecting earnings and profits.

II.

The Commissioner did not persist in applying the regulation in the sense supposed by this Court.

This will already have become apparent. We need to add here only the comment that the true course of the attitude toward the regulation within the Bureau of Internal Revenue appears to have been that during the first six years of its existence it was not interpreted as applying to a case of the *Wheeler* type. This fits in with the fact apparent in the record of this case—that the *Wheeler* deficiency assessment of February 1941 still made no reference to the regulation and was based exclusively upon the conception that the 1940 Act applied retroactively (R. 12-13).

We now give the history of the regulation⁴: The regulations under the 1932 Act (Art. 623 of Regs. 77), contained this sentence:

"In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive."

The apparent purpose was to insure that accounting substance should be followed rather than accounting form. "The facts" were the facts relevant to whatever might be the conception of "earnings or profits" in corporate law generally. They were not to be subverted by "mere bookkeeping entries."

An additional regulation in Regs. 77 (prior to 1934) was Art. 621:

"The term 'dividends' for the purpose of Title I * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913."

This was followed by a sentence, not here material, relating to non-taxable interest on State bonds.

In writing Regs. 86 the Commissioner inserted, after the last-quoted sentence from Art. 621 of Regs. 77, the following as the second and third sentences of the new Art. 115-1:

⁴The regulations under the various Acts are set forth in the Appendix to this petition.

"Among the items entering into the computation of corporate 'earnings or profits' for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains or losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent that such gains and losses are recognized under that section."

The first of these sentences was thus of a general character and related to the same subject-matter as the previous sentence—actual "corporate 'earnings and profits.' " Its function was to insure that actual items would not be excluded merely because taxless. It did not change the rule of the first sentence. The paragraph as a whole deals with actual "corporate" gains or losses. Now the third sentence, with which we are directly concerned, deals with *one* of the items of such *actual* income. This item was "gains and losses within the purview of section 112". The phrase obviously covers a subject-matter with two elements: (1) gains and losses as such—*actual* gains and losses; but among those only (2) such as are purviewed by section 112, which must mean such as section 112 applies to and changes the status of, i.e., such as have existence in their quality of gain or loss independently of section 112 but to which section 112 ascribes a particular quality for tax purposes, that of non-recognition. These were to be brought in "only" at the time and to the extent recognized.

We respectfully submit that it is a complete distortion of the sentences taken together to say that the second one was intended to introduce a new and independent subject-

matter,—the subject of some form of gain or loss not actual or realized at all.

This submission on our part is strengthened by two further related considerations:

First. As thus first adopted in 1934, the second sentence under consideration referred to the taking of the gains or losses into the earnings and profits "account". This implied that it was to be taken into something that could, from the viewpoint of corporate law or accounting, be a regular corporate "account", and not something which would derive its validity only from some conception of tax law.

Second. When the word "account" was dropped out of the later redraft of the regulation—as it appears e.g. in Art. 115-3 of Regs. 101 under the 1938 Act—it was dropped out because there was incorporated into the paragraph in its first sentence the concept of corporate accounting, upon the basis of real facts, which we first quoted above from Art. 623, Regs. 77 of 1932. The combined article then read thus:

"Art. 115-3. Earnings or profits.—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of

prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends."

We respectfully submit that when this paragraph is read as a whole, it will be apparent that the whole purpose was to confine "earnings or profits" to the actual facts. First, we are told that it is to the facts that consideration is to be given—not to mere bookkeeping entries. Then we are given a list of examples of typical actual income, partly taxable and partly non-taxable, but all actual. Then we are told that one of the items is not to be brought in until recognized.

The whole question in this case is whether that third sentence introduced a new subject (as this Court supposed in its earlier opinion) or whether it dealt with a particular item within the subject-matter of the two sentences which it followed.

It was apparently some time during the course of the year 1941 that it occurred to someone in the Bureau that the regulation might be argued to be applicable to the *Wheeler* type of case, for the argument made its initial appearance in *Falkland* in November 1941 and was followed in *Senior* and *Fisher* in 1943 and 1944.

By that time the Board of Tax Appeals of course considered that the contrary interpretation of the statute had

been firmly established by *Farish, W. & K.* and *Elmhirst*. It accordingly rejected the new argument in each of the three later cases—*Falkland, Senior* and *Fisher*.

Nor can it be suggested that the new argument arose out of the fact that these were the first cases dealing with a statute under which the regulation had been issued, for *Dorothy Whitney Elmhirst* was governed by the 1934 Act; yet the Commissioner did not argue that the regulation applied, although the case was considered as late as 1940.

Such suggestion would of course be without weight in any event, as the regulation purports to define and amplify the statute, not to change it. The regulation could therefore have been equally well relied upon by the Commissioner in *Farish* and *W. & K.*, each of which was decided in 1938, *ergo* more than three years after the adoption of the regulation. (Of course, if the regulation had been relied upon in *W. & K.*, the Commissioner would have had to confess error, for it was in that case that he was arguing that the statute had the opposite meaning.)

Thus we see that what the Commissioner did was to persist throughout six years in the position that the regulation did *not* apply to the *Wheeler* type of case. It is true that he twice argued that that was the true interpretation of the statute itself (albeit once he argued the contrary); but that was the argument thrice rejected by the full Board of Tax Appeals. If the *Dobson* case means anything, the Commissioner is not entitled to the application of the "principles" in regard to regulations to which this Court made reference in the final paragraph of its opinion (Slip Op. 4, and footnote 10):

We now turn to an entirely different type of case:

(a) The type that really did give rise to the regulation,

(b) and to which the Commissioner really did persist in applying the regulation.

III.

The regulation properly applies to a case in which the transferor of property in a tax-free reorganization has as a corporate accounting matter realized actual gain upon the transfer.

The question is when that actual gain is taken into earnings and profits account.

The error into which we respectfully submit that this Court fell in the first opinion in this *Wheeler* case is traceable to an omission to distinguish between cases of two diverse types and having a conflicting history.

We have reviewed the cases of the first type,—the type presented in the *Wheeler* case. Its characteristic is that the dividend-paying corporation was the transferee of property upon which it did not ever itself realize an actual gain, but in respect of which the question arose whether there should be ascribed to it a gain or loss measured by reference to transferor's basis.

The second type of case which we will now consider, is the case in which the other party to the reorganization,—the transferor of the property,—became itself the dividend-paying corporation. In that type of case, the transferor did realize an actual gain or loss of its own upon the transfer. Because of the reorganization provisions no tax was recognized to it, however. The question that then arose was

whether, because the gain or loss had not yet been recognized, the corporation could avoid taking into its earnings and profits account the gain or loss that it had actually realized.

The question first arose in *Forhan Realty Corporation* (Memorandum Opinion in B. T. A., unreported; Docket No. 60975, decided June 16, 1933), reported on appeal when affirmed by C. C. A. 2d, *Commissioner v. Forhan Realty Corporation* (Feb. 4, 1935) 75 F. (2d) 268. The taxpayer owned shares in another corporation called the Forhan "Company". The "Company" had transferred all its assets in a tax-free reorganization to Zonite Products Corporation in exchange for common stock of Zonite and cash, which the "Company" then distributed to its shareholders, including the taxpayer. Actual gain was realized by the "Company" because the value of the Zonite stock and cash exceeded the cost of the assets transferred by the "Company" in exchange for them.

The case therefore turned in part upon whether the actual but unrecognized gain of the "Company" upon the exchange entered into the earnings and profits of the "Company". If it did, then the distribution to its stockholder (the taxpayer) was a dividend, and since the taxpayer was a corporation, it was non-taxable. If it did not, then the distribution was a return of capital and, to the extent only that it exceeded the cost of the stock to the taxpayer, would represent a taxable capital gain.

The Commissioner argued that under the statute (the same then as now) the gain was *not* to be taken into earnings and profits. The Board of Tax Appeals held that the gain upon the reorganization was to be taken forthwith into earnings and profits, because it was an actual corporate gain, although not yet recognized for tax purposes.

That decision, of course, opened a wide avenue of tax avoidance. The gain had not been recognized to the "Company" at the time it received the Zonite stock, and if the Zonite stock were distributed as a dividend to a corporate shareholder, no income tax would be paid upon that gain. The tax basis of the Zonite stock received as a dividend in the hands of the corporate shareholder would be its fair market value on the date it was received, and the corporate shareholder could subsequently sell such stock without the realization of gain.

The government appealed to the Circuit Court of Appeals for the 2nd Circuit, the brief being filed in September 1934. The Circuit Court of Appeals affirmed, *Commissioner v. Forhan Realty Corporation*, 75 F. (2d) 268 (C. C. A. 2d, Feb. 4, 1935).

Accordingly, that was the tax avoidance situation with which the Commissioner was faced at the time he promulgated his regulation (in early 1935).

The regulation was designed to postpone the bringing of actual gain into earnings and profits until "such gains * * * are recognized."

The purpose of the regulation was the opposite of what this Court now supposes; it was to *prevent* gain being brought into earnings and profits where the effect might be to lose tax upon it because it was disbursed as a non-taxable dividend, before tax accrued.

The question next arose in a case involving an individual taxpayer. But the principle was precisely the same, as the taxpayer's position is governed by that of the corporation making the distribution. However, before the taxation of intercorporate dividends in 1936, there might be a critical difference in the result. Where the tax-

payer was a corporation, as in *Forhan*, the Commissioner was asking that the gain should not be taken into earnings and profits; but where the taxpayer was an individual, and the capital gains tax rate was lower than the surtax rate on the dividend, the needs of the Revenue would favor the gain being taken immediately into earnings and profits account.

The Board of Tax Appeals consistently held in respect of individuals, as it had held in respect of corporate taxpayers in *Forhan*, that the gain upon the reorganization, although not recognized for tax purposes, was immediately taken into earnings and profits. And in the individual cases, as we have indicated, the Commissioner was content with the rule. The first such case was *Susan T. Freshman* (Nov. 1935) 33 B. T. A. 394. The facts underlying the decision are clearly stated in the following paragraph from the Board's opinion, 33 B. T. A. at 401:

"The Pratt & Whitney Co. invested \$500 of its earnings in 1925 in common stock of Pratt & Whitney Aircraft Co. This stock had increased enormously in value by 1929 and was exchanged in February 1929 solely for stock of United Aircraft Co. but the gain on the exchange was not recognized under the provisions of section 112(b)(3). The increase in value of the investment, which, after the exchange, was represented by the property received on exchange, was available for distribution as a dividend and was distributed by Pratt & Whitney to its sole stockholder, Niles-Bement-Pond. This dividend was an earning of Niles-Bement-Pond on its Pratt & Whitney stock, which earning was received on February 11, 1929, and was available for distribution by Niles-Bement-Pond to its stockholders. Niles-Bement-Pond immediately dis-

tributed practically all of the property received by it as a dividend to its stockholders. This was a distribution by a corporation to its stockholders in property out of earnings received after February 28, 1913."

The decision was reviewed by the Board and established the law in the Board on the question.

In another case three months later, the Board reached the identical result. *Robert R. McCormick* (Feb. 1936) 33 B. T. A. 1046. This decision was also reviewed by the Board.

The question arose again in the case of a corporate taxpayer before the 2nd Circuit Court of Appeals in *Ramapo Inc. v. Commissioner* (July 1936) 84 F. (2d) 986. The question had not been considered in the Board of Tax Appeals (32 B. T. A. 561), but was made a ground of decision in the C. C. A., 84 F. (2d) at 988. Like the *Forhan* situation, there had been a great increment in value, non-taxable because realized upon a reorganization, consequent upon transfer by Superpower Corporation of various securities which it exchanged for stock of United Corporation. The distribution to Superpower's stockholders (of which the taxpayer was one) was of rights to buy stock in United. The ground of decision was that those rights were to be taken to be a distribution out of the earnings and profits which had been provided by the great increment in value of the United stock over the securities transferred to Superpower in exchange therefor.

The *Ramapo* case involved a very large amount and provided striking confirmation of the risk of loss to the Revenue which had been forecast by the earlier decision of the same Court in *Forhan*, for the distributee corporate

stockholders avoided taxes upon the distribution, notwithstanding that no tax had been recognized to the distributor corporations. The Commissioner therefore filed a petition for rehearing, and Mr. Justice Jackson appeared on the Commissioner's brief as Assistant Attorney-General. The Commissioner's brief, in pointing out the avoidance of tax that resulted from taking into earnings and profits account the gains that had not themselves (because of the reorganization provisions) been recognized for tax purposes, made the first reference which we have found in any of the Commissioner's briefs to the regulation here under consideration, saying of it (in a footnote):

"In Article 115 (1) of Regulations 86 promulgated under the Revenue Act of 1934, it is provided that gains are to be brought into the profits and loss account for the purpose of determining the earnings available for dividends *only* when they are recommended³ under section 112." [Emphasis ours.]

The petition for rehearing was denied; but the Commissioner did not petition for a writ of certiorari.

Another case of an individual taxpayer arose before the Board in *Helen Sperry Lea* (Jan. 1937) 35 B. T. A. 243, and, after being reviewed by the Board, was decided in the same way, upon the authority of the *McCormick* case, *supra*, 33 B. T. A. 1046.

³Evidently a misprint for "recognized". The word "only" shows what was in the brief-writer's mind, viz. that the regulation related to some gain that had in fact been realized and that the question was as to *when* such actual corporate gain was to be taken into earnings and profits account. To this the brief-writer answered: "'only' when they are recognized under section 112."

It had now become established in the Board of Tax Appeals by five cases, two of which had been affirmed in the 2nd Circuit Court of Appeals, that the actual but taxless gains of a corporation were taken into earnings and profits so that distributions therefrom were to be treated as dividends. And this was settled as a matter of principle, regardless of whether the taxpayer happened to be an individual or a corporation, although under the law as to dividends as it stood prior to 1936, this meant that each case of an individual taxpayer was decided in favor of the Commissioner and each case of a corporate taxpayer was decided against the Commissioner. In this branch of the law, as in the other branch considered above, the Commissioner at this period, far from being "persistent" in applying a regulation, was arguing as best he could in support of whatever rule would in the particular case be favorable to the Revenue.

The sixth case of this sort, and the third involving a corporate taxpayer, was *F. J. Young Corporation* (April 1937) 35 B. T. A. 860. The Board pointed out in parallel columns the fact that the cases of individual and corporate taxpayers were indistinguishable, and decided in favor of the taxpayer on the authority of the decision in favor of the Commissioner in *Freshman, supra*, 33 B. T. A. 394. The Board was in *F. J. Young* simply continuing its perfectly consistent course, and it was not considered necessary for *F. J. Young* to be reviewed by the full Board. The Commissioner again appealed, however, this time to the 3rd Circuit Court of Appeals; but the 3rd Circuit Court of Appeals agreed with the 2nd Circuit and upheld the Board's view. *Commissioner v. F. J. Young Corporation* (March 1939) 103 F. (2d) 138.

The Commissioner was now ready to acquiesce in the position that a certain rule had become settled in the Courts, and (as with the earlier decisions of the 2nd Circuit), he did not apply for a writ of certiorari to this similar decision in the 3rd Circuit. He took the other course,—of seeking an amendment of the statute,—and obtained it in the 1940 Act which has been considered in this case.

That it was the *F. J. Young* decision that led to the enactment of the 1940 statute, is evidenced by the fact that it was that case and its precise facts which were cited in reports both of the House and of the Senate recommending the legislation. H. R. Rep. 2894, 76th Cong. 3d Sess., and Sen. Rep. 2114, 76th Cong. 3d Sess., both referred to in footnote 7 of this Court's opinion in this case, Slip Op. 3.

F. J. Young was the final case of the second group. It was decided in March 1939. A C. C. A. decision of the first group was *Farish* in the 5th Circuit in July 1939 (four months later). If the Congress or the Commissioner considered that the questions were linked, one would have expected the *Farish* case to be considered and cited in the enactment of the 1940 Act just as the *Young* case was. But it was not. The evident intent of Congress was to change the doctrine of the *Young* case, which (as we have said) was used as the example in the House and Senate Reports. There is no indication in the Congressional history that the rule in the *Farish* case was meant to be affected at all.

IV.

Nor did Congress by the enactment of § 501 of the Second Revenue Act of 1940 evidence any intention to alter the established rule that only actual gains and losses enter into the computation of earnings and profits.

§ 501(a) refers repeatedly in terms to "realized" gains and losses, i.e., to actual gains and losses. (Our original brief Point II, pp. 30-40.) The statute is set forth in the Appendix to this petition.

But even assuming that Congress, by the Second Revenue Act of 1940, did intend to abolish the rule that only actual gains and losses enter into the computation of earnings and profits, the fact that Congress refused to apply the new statute to pending litigation shows clearly that it thought it was changing existing law by the 1940 statute. If this Court permits an ambiguous statement in a committee report that legislation is "clarifying" to prevent its being retroactive, no legislation ever need be retroactive; it can always express itself as "clarifying".

Recent decisions of this Court confirm the rule that a Treasury Regulation, which has no statutory basis, cannot be given effect. *Maass v. Higgins*, 312 U. S. 443. *Helvering v. Credit Alliance Corporation*, 316 U. S. 107. *Helvering v. Sabine Transportation Company, Inc.*, 318 U. S. 306. The Treasury Regulation in the instant case had no statutory basis. Congress did not legislate on the subject until it passed the Second Revenue Act of 1940.

V.

The phrase "for the purposes of this title" does not have the significance conjecturally assigned to it in the opinion of this Court.

This Court felt moved to conjecture as to the intent of Congress (saying, at Slip Op. p. 4, that "Congress appears to have provided") that the taxable, i.e., recognized, gain or loss should be the gain or loss to be taken into earnings and profits, because § 111(c) of the 1938 Act says that gain or loss shall be "*recognized for the purposes of this title.*" The italicized phrase is the only direct evidence of Congressional intent to which the Court's opinion points.

This Court doubtless did not realize that the phrase is contained at least fifteen times in the Revenue Act of 1938, and that similar expressions are contained numerous additional times. The phrase is used synonymously with expressions such as "as used in this title" or "when used in this title". Its unimportance as a substantive provision is high-lighted by the fact that the Committee Reports with respect to § 202(d) of the Revenue Act of 1924 (the predecessor of § 111(c)) omit the phrase altogether in paraphrasing the section. For instance, the Senate Finance Committee Report (Senate Report 398, 68th Cong., 1st Sess., p. 13) states:

"(4) Subdivision (d) [111(c)] is merely informative, stating that the amount of the gain determined under its provisions shall be recognized as provided in section 203 [112], which states those cases in which no gain or loss from a sale or exchange is recognized in those cases in which a limitation is placed upon the gain or loss to be recognized from the sale or exchange."

The phrase "for the purposes of this title" is used in §§ 13, 14, 332, 335, 336, 362, 405 and 406 of the 1938 Act with respect to definitions of taxable net income. It is used, together with the synonymous phrase "as used in this title", three times in § 117 of the 1938 Act, which defines the extent to which gains and losses are to be taken into account in computing taxable income. It is frequently used in connection with other definitions in the Act; see for instance §§ 272(h), 331(a), 361 and 402. The phrase "as used in this title" also is synonymously used in §§ 26, 27(a) and 271(a). The phrase "when used in this title" is used in § 48 and § 115.

Accordingly, if any significance is to be given to the phrase "for the purposes of this title", it can equally well be applied to evince a Congressional intention to conform earnings and profits to taxable income. If that be so, the Wheeler Company had a deficit. See Part Two of this petition.

PART TWO

**Assuming the Court's Interpretation to Be Right,
the Decision Below Must Be Affirmed on the Facts of
This Case.**

I.

The gains were prior to the regulation.

The regulation provides that gains and losses are to be taken into earnings and profits account "at the time" such gains and losses are recognized under section 112.

The regulation was promulgated in 1935 applicable to the 1934 and succeeding Acts.

At that time the earnings and profits account for 1933 and all prior years was closed.

But the full amount involved in this case results from transactions in 1931, 1932 and 1933 (R. 17).

In 1933 there occurred under the Court's decision a gain of \$155,911.86. There was no regulation then in effect; and the gain was not an "earning or profit" under section 115; nor was it taken into "earnings or profits account."

When in the year 1935 the regulation came to be promulgated, however, it negated the suggestion now implicit in the Court's opinion that it was applicable to these particular gains, for "the time" when it directed that such gains should be taken into "earnings or profits account" was already past.

The Court has properly treated the regulation not as merely interpretative but as directive.

We are not saying that a regulation of this character could not be retroactive. We are only following this Court

in giving to the regulation its literal meaning. As that meaning is to prescribe a time when gains "shall be taken into" some account, it negatives retroactivity in application.

The regulation does not say that prior gains shall be treated as if they had been taken into earnings or profits account.

II.

The gains are more than offset by non-taxable dividends to which the Court's theory equally applies.

This Court held that the "theory" ought to be "carried through":

"It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits" (Slip Op. 3).

The theory was

"that in certain types of transactions the economic changes are not definitive enough to be given tax consequences" (*op. cit.*).

One type of transaction from which until 1936 the Congress withheld tax consequences was an intercorporate dividend.

In this case if the intercorporate dividends prior to 1936 be eliminated, the Wheeler Company still had a deficit even if the "gain" now under consideration be taken into earnings and profits.

Those non-taxable dividends were included by the Commissioner in determining the Company's earnings and profits (R. 17, 18). If actual income no longer be the test for determining earnings and profits, that \$203,085.19

should be eliminated from the earnings of the Company. That would more than offset the Commissioner's addition of \$179,314.99 on account of taxable "gains" with respect to sales of securities on which the Company had an actual loss. The \$203,085.19 of non-taxable dividends was also (to quote this Court) a "figure that had no relation to taxation" (Slip Op. p. 3). It is as "reasonable" to eliminate that figure as to add the "gain"; if reasonableness be the test.

"Carrying through" the Court's "theory", therefore, that tax consequences for earnings and profits purposes are not to attach to transactions from which the Congress withheld tax consequences for recognition of income purposes, the decision below must be affirmed.

WHEREFORE the respondents, by their counsel, respectfully pray that this case be reheard and reconsidered.

Respectfully submitted,

ELLIOTT H. WHEELER, *et al.*,
Executors of the Estate of JOHN
H. WHEELER, Deceased, *et al.*,
Respondents,

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ROSWELL MAGILL
GEORGE G. TYLER

Of Counsel

April 17, 1945.

Certificate of Counsel

I, WM. DWIGHT WHITNEY, counsel for the respondents herein, do hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay and that this certificate is made pursuant to Rule 33 of the rules of this Court.

WM. DWIGHT WHITNEY

Motion to Withhold Issuance of Mandate

The respondents herein move this Court for an order enlarging the time for the issuance of mandate to the end that the mandate be withheld until after the disposition of the foregoing petition for rehearing.

WM. DWIGHT WHITNEY
Counsel for Respondents

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

TITLE I—INCOME TAX

* * *

SUBTITLE C—SUPPLEMENTAL PROVISIONS

* * *

SUPPLEMENT B—COMPUTATION OF NET INCOME

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * *

(5) *Transfer to Corporation Controlled By Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * *

(6) *Tax-free Exchanges Generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112(b) to (e), inclusive, the basis (except as provided in paragraph (15), (17), or (18) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned

to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * *

(8) *Property Acquired by Issuance of Stock or as Paid-in Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of the section

v

are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

* * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

TITLE V—AMENDMENTS TO INTERNAL REVENUE CODE

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

“(1) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

“(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

“(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the

adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided.

* * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States. (26 U. S. C. Supp. III, Sec. 115.)

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

Art. 621. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 208 (c) (1)) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, upon amalgamation with the other funds of the corporation such income loses its identity and when distributed to shareholders in dividends is taxable to the same extent as other dividends.

* * *

Art. 623. *Distributions out of earnings or profits accumulated, or increase in value of property accrued, prior to March 1, 1913.*—* * *

In determining whether a dividend is out of earnings or profits accumulated since February 28, 1913, or prior to March 1, 1913, due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Art. 115-1. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 207 (c) (1)) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section. Although interest on State bonds and certain other obligations is not taxable when received by a corporation, when distributed to shareholders in dividends is taxable to the same extent as other dividends.

○ Treasury Regulations 94, promulgated under the Revenue Act of 1936; and Treasury Regulations 101, promulgated under the Revenue Act of 1938:

Art. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated

prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

HOUSE COMMITTEE REPORT

THE SECOND REVENUE BILL OF 1940

H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940-2 Cum. Bull. 496, 526-527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (1) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of sec-

tion 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112 and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner v. Sansome* (60 Fed. (2d), 931) and following decisions, the rule effectuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X Corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was \$100. The fair market value of the stock in the Y Corporation received by the X Corporation was \$1,000. On April 9, 1930, the X Corporation declared a cash dividend of \$900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, \$900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner v. F. J. Young Corporation*, 103 Fed. (2d), 137). Under the proposed legislation and Treasury practice, the \$900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

SUPREME COURT OF THE UNITED STATES.

No. 354.—OCTOBER TERM, 1945. ⁴

Commissioner of Internal Revenue,

Petitioner,

vs.

Elliott H. Wheeler, et al., Executors
of the Estate of John H. Wheeler,
Deceased, et al.

On Writ of Certiorari to
the United States Circuit
Court of Appeals for the
Ninth Circuit.

[March 26, 1945.]

Mr. Justice JACKSON delivered the opinion of the Court.

The Circuit Court of Appeals for the Ninth Circuit has held Section 501(a) of the Second Revenue Act of 1940 to be unconstitutional.¹ This of course called for grant of certiorari.²

Since our problem is not computation of a tax, the facts relevant to the issues in the five cases, consolidated on appeal, may be shortly stated. In 1925, John H. Wheeler and his wife, Frances, organized under the laws of California the John H. Wheeler Company. Then and thereafter they transferred an assortment of securities to it in exchange for shares of its common stock. The securities had cost them \$304,683.49 and at transfer had a fair market value of \$491,800. In exchange the Wheelers received 4918 shares with a par value of \$100 each. No gain by them was recognized for income-tax purposes by reason of the exchange. Cf. Int. Rev. Code § 112(b)(5).

For purposes of determining its income-tax liability on subsequent disposition of the securities, the corporation was obliged to and did use as a cost base the cost of the securities to the transferors, \$304,684.49. Cf. Int. Rev. Code § 113(a)(8). But for its corporate accounting the corporation set up a cost of \$491,800, market value at the time of acquisition in exchange for common stock of equal par value. The whole question in this case is which of these bases is to be used to compute, pursuant to § 112(b)(7)(E) of the Revenue Act of 1938, 52 Stat. 447, 488, the amount of "earnings and profits" distributed as liquidating dividends. The Act of 1938, to induce corporate liquidations, permitted a qualified stockholder to elect postponement of a portion of the gain realized on a December 1938 liquidation and to be taxed, as for a dividend,

¹ 143 F. 2d 162.

² — U. S. —.

2. *Commissioner of Internal Revenue vs. Wheeler et al.*

on "so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation" If the market-value basis is used for the securities acquired from the Wheelers and later sold, the operations of the Company showed a deficit on November 30, 1938, when the books were closed. If the cost-to-transferors basis is used, "earnings and profits" were distributed to respondents, the stockholders, in the amount of \$132,813.48, as computed by the Commissioner.³

After considering the applicability of § 112(b)(7), the stockholders duly dissolved the corporation and distributed its assets during December 1938. They elected to be taxed on the gains on their shares pursuant to § 112(b)(7), and they reported, of course, according to the higher or market-value basis for the securities acquired and disposed of by the Company. The Commissioner asserted a deficiency based on the lower cost to the transferors. In explaining his determination he relied on § 501(a) of the Second Revenue Act of 1940, 54 Stat. 974, 1004, which provides that earnings and profits on the sale or other disposition of property shall be determined by using the adjusted basis for determining gains and by recognizing such gains to the extent that they are recognized for computing net income, and on § 501(c), which makes the provisions of § 501(a) applicable to prior years.

The Tax Court sustained the Commissioner.⁴ It held § 501(a) of the Act of 1940 a "complete answer" to taxpayers' contention, and it overruled their claim that if the section was applicable to increase their 1938 liability it was retroactive in contravention of the Fifth Amendment to the Constitution. The Circuit Court of Appeals agreed that the section was applicable, but held that such retroactivity rendered it unconstitutional.

Although the term "earnings and profits" has long been in the revenue acts, in connection with the definition of dividends, it has never been defined by the statutes⁵ (except in so far as § 501(a) of the Second Act of 1940 has now done so). But under the Revenue Act of 1934 and succeeding acts, the Commissioner dealt by regulation with that portion of the problem of definition relevant here. Article 115-3 of Treasury Regulations 101, promulgated under the 1938 Act, provided in part as follows: "Gains and losses within the purview of Section 112 or corresponding

³ This was slightly modified by the Tax Court in an aspect not material here.

⁴ 1 T. C. 649.

⁵ See Paul, *Selected Studies in Federal Taxation* (Second Series, 1938) 149, 155 *et seq.*

provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. This regulation, if valid, disposes of the controversy, for when the corporation sold its securities acquired from the Wheelers it realized gain, based on transferor's cost, which was fully recognized under § 112.

The only reason to doubt the validity of the regulation is found in certain decisions of the Board of Tax Appeals and lower courts, mentioned in the Tax Court's opinion. Despite these adverse decisions, however, the Commissioner persisted in applying the regulation. The question was never reviewed here. Before it was finally judicially considered, Congress enacted § 501 of the Second Revenue Act of 1940, as the committee reports show,⁷ to "clarify the law" by enacting the substance of the regulation. But if the regulation itself was valid and effective, the clarifying amendment of 1940 added nothing to the liability of these taxpayers; and even though the Tax Court relied on it rather than on the regulation, no question of retroactivity is presented.

We think the regulation is reasonable and a valid exercise of the rule-making power. The taxpayers are insisting on using as a base for tax purposes a figure that in itself had no relation to taxation. It was no doubt permissible and perhaps the correct accounting, for determining earned surplus for dividends and such corporate purposes, for the corporation to set up its books on the market value of its property at the time of acquisition, which determined the value of the stock it issued. But "earnings and profits" in the tax sense, although it does not correspond exactly to taxable income, does not necessarily follow corporate accounting concepts, either.⁸ Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income-tax liability but shall be taken account of later. §§ 112, 113. It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits. Compare *Commissioner v. Sansome*, 60 F. 2d 931, and see Sen. Rep. No. 2156, 74th Cong., 2d Sess., p. 19; H. R. Rep. No. 2894, 76th Cong.,

⁷ The provision appears in Reg. 94, Art. 115-3, under the Act of 1936; Reg. 86, Art. 115-1, under the Act of 1934; and in Reg. 103, Sec. 19.115-3 and Reg. 111, Sec. 29.115-3 under the Internal Revenue Code.

⁸ See H. R. Rep. No. 2894, 76th Cong., 3d Sess., p. 41; Sen. Rep. No. 2114, 76th Cong., 3d Sess., p. 22.

⁹ See 1 Mertens, Law of Federal Income Taxation (1942) § 9.33.

3d Sess., p. 47. Indeed, Congress appears to have provided for this result in the statute itself (§ 111(c) of the 1938 Act), which declares: "In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112."⁹ In this case, to be sure, there was no question of recognition of gain or loss to the corporation at the time of the exchange with the Wheelers, because it was issuing its own stock and so realized no gain or loss. But to recognize the increment in value as affecting earnings and profits would no more harmonize with the taxless character of the transaction than to treat a realized gain as doing so. The same policy which carries over the transferor's basis for purposes of the corporation's income tax (§ 113(a)(8)) requires carrying it over for determining the taxability of its distributions, as the Commissioner's regulation directs: gains and losses are to be brought into earnings and profits at the time and "to the extent" that they are recognized under § 112. Finally, no doubt of the reasonableness of the rule can linger in the presence of § 501(a), by which Congress has indicated its express approval of the principle that the basis for determining earnings and profits shall be the basis for determining gain.

We therefore think that on principles often reiterated¹⁰ the regulation is valid and decisive of this issue. There is no necessity to predicate the determination of deficiency on the 1940 amendment. The 1940 amendment consequently has no retroactive effect on the liability of these taxpayers; and the conclusion of the Court of Appeals that it is unconstitutional is not warranted. The judgment of the Court of Appeals is reversed and that of the Tax Court is affirmed.

Reversed.

Mr. Justice ROBERTS is of opinion the judgment should be affirmed for the reasons stated by the Circuit Court of Appeals, 143 F. 2d 162.

⁹ (Ital. supplied.) See Paul, *Selected Studies in Federal Taxation* (Second Series, 1938) 193-95.

¹⁰ *Boske v. Comingore*, 177 U. S. 459, 470; *Brewster v. Gage*, 280 U. S. 327, 336; *United States v. Kirby Lumber Co.*, 284 U. S. 1, 3; *Fawcett Machine Co. v. United States*, 282 U. S. 375, 378. It may also be noted that the regulation has the support of the doctrine that re-enactment of the statute without disapproval of regulations thereunder gives them added sanction. *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459, 466; *Helvering v. Winmill*, 305 U. S. 79, 83; *Helvering v. Griffiths*, 318 U. S. 371, 395, 397.